Final Course

(Revised Scheme of Education and Training)

Study Material

(Modules 1 to 4)

PAPER 1

Financial Reporting

MODULE – 1

BOARD OF STUDIES

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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BEFORE WE BEGIN …

The role of a chartered accountant is evolving continually to assume newer responsibilities in a dynamic environment. There has been a notable shift towards strategic decision making and entrepreneurial roles that add value beyond traditional accounting and auditing. The causative factors for the change include globalisation leading to increase in cross border transactions and consequent business complexities, significant developments in information and technology and financial scams underlining the need for a stringent regulatory set up. These factors necessitate an increase in the competence level of chartered accountants to bridge the gap in competence acquired and competence expected from stakeholders. Towards this end, the scheme of education and training is being continuously reviewed so that it is in sync with the requisites of the dynamic global business environment; the competence requirements are being stepped up to enable aspiring chartered accountants to acquire the requisite professional competence to take on new roles.

Concurrent Practical Training along with academic education: Key to achieving the desired level of Professional Competence

Under the Revised Scheme of Education and Training, at the Final Level, you are expected to apply the professional knowledge acquired through academic education and the practical exposure gained during articleship training in addressing issues and solving practical problems. The integrated process of learning through academic education and practical training should also help you inculcate the requisite technical competence, professional skills and professional values, ethics and attitudes necessary for achieving the desired level of professional competence.

Indian Accounting Standards (Ind AS): High Standards of Financial Reporting

Consistent, comparable and understandable financial reporting is essential to develop a robust economy. High standards of financial reporting underpin the trust investors place in financial and non-financial information. Thus, the case for a single set of globally accepted accounting standards has prompted many countries to pursue convergence of our national accounting standards (I GAAP) with IFRS.

The Government of India in consultation with the ICAI decided to converge and not to adopt IFRS issued by the IASB. The decision of convergence rather than adoption was taken after the detailed analysis of IFRS requirements and extensive discussion with various stakeholders. Accordingly, while formulating IFRS-converged Indian Accounting Standards (Ind AS), efforts have been made to keep these Standards, as far as possible, in line with the corresponding IAS/IFRS and departures have been made where considered absolutely essential. These changes have been made considering various factors, such as, various terminology related changes have been made to make it consistent with the terminology used in law, e.g., 'statement of profit and loss' in place of 'statement of comprehensive income' and 'balance sheet' in place of 'statement of financial position'. Certain changes have been made considering the economic environment of the country, which is different as compared to the economic environment presumed to be in existence by IFRS.

Thereafter, the Ministry of Corporate Affairs (MCA) had notified IFRS-converged Indian Accounting Standards (Ind AS) as Companies (Indian Accounting Standards) Rules, 2015 vide Notification dated February 16, 2015 and also the roadmap for the applicability of Ind AS for certain class of companies from financial year 2016-17. With the beginning of financial year 2016-17, the era of implementation of Ind AS in India has also begun for the companies falling under Phase I of the MCA roadmap for implementation of Ind AS. The MCA has also laid down roadmap for implementation of Ind AS for NBFCs. These developments are a significant step in achieving international benchmarks of financial reporting.

Ind AS, at the Final level, involves understanding, application and analysing of the concepts and testing of the same. The nitty-gritties of this new standard coupled with its inherent dynamism, makes the learning, understanding and application of the standards in problem solving very interesting and challenging.

Know your Syllabus

Accounts being the core competence areas of chartered accountants, at Final level, the syllabus of Financial Reporting largely covers Indian Accounting Standards and contemporary topics in Accounting and Reporting. However, for understanding the coverage of syllabus, it is important to read the Study Material as the content therein has been developed keeping in mind the extent of coverage of various topics in commensuration with 100 marks allotted to the paper. Certain Ind AS / portion of Ind AS are excluded from the study material, keeping in view the relevancy of the content in the Indian scenario and also to avoid the volume of the study material. However, while discussing the relevant applicable provisions, a reference may have been made to some of these excluded Ind AS / portion of Ind AS at certain places.

For understanding the coverage of syllabus, it is important to read the Study Material along with the reference to Study Guidelines. The concept of Study Guidelines is being introduced in the Revised Scheme of Education and Training in this subject, in line with international best practices, to specify the topic-wise exclusions from the syllabus. Therefore, the Study Guidelines, contain the detailed topic-wise exclusions from the syllabus.

Know your Study Material

Efforts have been made to present the multifaceted Ind AS in a lucid manner. The Study Material carries 18 chapters. Care has been taken to present the chapters in a logical sequence to facilitate easy understanding by the students. Ind AS have been grouped under various categories to make you understand the areas of relevancy and application of Ind AS. The chapters have been numbered based on those categories and Ind AS falling in the same category are included in that chapter. Therefore, certain chapters on Ind AS, contain several units each unit dedicated to one Ind AS. However, for bare text of Indian Accounting standards, students are advised to refer the notified Indian Accounting Standards uploaded on the website at the link https://www.icai.org/post.html?post_id=15365

With respect to accounting of certain contemporary topic on 'Corporate Social responsibility Reporting' forming part of the syllabus, accounting both as per AS and Ind AS have been discussed, wherever possible.

The various chapters/units of this subject have been structured uniformly and comprise of the following components:

	Components of each Chapter	About the component
1.	**Learning Outcomes**	Learning outcomes which you need to demonstrate after learning each topic have been detailed in the first page of each chapter/unit. Demonstration of these learning outcomes will help you to achieve the desired level of technical competence.
2.	**Chapter / Unit Overview**	As the name suggests, the flow chart/table/diagram given at the beginning of each chapter will give a broad outline of the contents covered in the chapter.
3.	**Content**	Ind AS have been explained by following a systematic approach of first discussing the objective, then the scope of the pronouncement and then extracting the underlying concepts. The concepts and provisions of Ind AS are explained in student-friendly manner with the aid of examples / illustrations / diagrams / flow charts. Diagrams and flow charts will help you understand and retain the concept / provision learnt in a better manner. Examples and illustrations will help you understand the application of concepts/provisions. Later, in the topics of Ind AS, the significant differences vis-à-vis AS has also been incorporated so that students appreciate and recapitulate their learning done at Intermediate level. These value additions will, thus, help you develop conceptual clarity and get a good grasp of the topic.
4.	**Illustrations involving conceptual understanding**	Illustrations would help the students to understand the application of concepts / provisions of accounting standards / guidance notes. In effect, it would test understanding of concepts / provisions as well as ability to apply the concepts / provisions learnt in solving

		problems and addressing issues.
5.	**Test Your Knowledge**	**Questions** This section comprises of variety of questions which will help you to apply what you have learnt in problem solving, and, thus, sharpen your application skills. In effect, it will test your understanding of concepts as well as your ability to apply the concepts learnt in solving problems and addressing issues. **Answers** After you work out the problems / questions given under the section "Test Your Knowledge", you can verify your answers with the answers given under this section. This way you can self-assess your level of understanding of the concepts of a chapter.

Though all efforts have been taken in developing this Study Material, the possibilities of errors / omissions cannot be ruled out. You may bring such errors / omissions, if any, to our notice so that the necessary corrective action can be taken.

We hope that the student-friendly features in the Study Material makes your learning process more enjoyable, enriches your knowledge and sharpens your application skills.

Happy Reading and Best Wishes!

REVISED SYLLABUS
(APPLICABLE FROM NOVEMBER, 2019 EXAMINATION)

PAPER – 1: FINANCIAL REPORTING

(One paper – Three hours – 100 Marks)

Objectives:

(a) To acquire the ability to integrate and solve problems in practical scenarios on Indian Accounting Standards for deciding the appropriate accounting treatment and formulating suitable accounting policies.

(b) To gain the prowess to recognize and apply disclosure requirements specified in Indian Accounting Standards while preparing and presenting the financial statements.

(c) To develop the skill to prepare financial statements of group entities which includes subsidiaries, associates and joint arrangements based on Indian Accounting Standards.

(d) To develop an understanding of the various forms of reporting (other than financial statements) and accounting for special transactions, and apply such knowledge in problem solving.

Contents:

1. **Framework for Preparation and Presentation of Financial Statements** in accordance with Indian Accounting Standards (Ind AS).

2. **Application of Indian Accounting Standards (Ind AS)** with reference to General Purpose Financial Statements

   (i) Ind AS on First time adoption of Indian Accounting Standards

   (ii) Ind AS on Presentation of Items in the Financial Statements

   (iii) Ind AS on Measurement based on Accounting Policies

   (iv) Ind AS on Income Statement

   (v) Ind AS on Assets and Liabilities of the Financial Statements including Industry specific Ind AS

   (vi) Ind AS on Items impacting the Financial Statements

   (vii) Ind AS on Disclosures in the Financial Statements

(viii) Other Ind AS

3. **Indian Accounting Standards on Group Accounting**

   (i) Business Combinations and Accounting for Corporate Restructuring (including demerger) (as per Ind AS)

   (ii) Consolidated and Separate Financial Statements (as per Ind AS)

4. **Accounting and Reporting of Financial Instruments** (as per Ind AS)

5. **Analysis of Financial Statements**

6. **Integrated Reporting**

7. **Corporate Social Responsibility Reporting**

Notes:

1. If either a new Indian Accounting Standard (Ind AS) or Announcements and Limited Revisions to Ind AS are issued or the earlier one are withdrawn or new Ind AS, Announcements and Limited Revisions to Ind AS are issued in place of existing Ind AS, Announcements and Limited Revisions to Ind AS, the syllabus will accordingly include / exclude such new developments in the place of the existing ones with effect from the date to be notified by the Institute.

2. The specific inclusions / exclusions in any topic covered in the syllabus will be effected every year by way of Study Guidelines.

SIGNIFICANT CHANGES

Significant changes in this Module 1 vis a vis November, 2018 edition - Module 2 of the Study Material *(The amendments made in the respective chapters / units have been highlighted in bold and italics for easy reference except newly added illustrations)*		
Chapter	**Chapter name (Ind AS)**	**Details**
2 unit 1	Ind AS 1 "Presentation of Financial Statements"	Theory of the chapter has been improved upon at several places and Illustrations 4 and 15 have been newly added.
4 unit 1	Ind AS 8 "Accounting Policies, Changes in Accounting Estimates and Errors"	Illustration 1 to 5, 7-8 and TYK questions 2-5 have been newly added.
4 unit 2	Ind AS 10 "Events after the Reporting Period"	Illustration 1 to 3, 5, 8-9, 11 and TYK questions 4-9 have been newly added.
4 unit 1	Ind AS 113 "Fair Value Measurement"	Theory of the chapter has been improved upon at several places and in 'Test Your Knowledge' part, questions 3-5 have been newly added.
6	Ind AS 101 "First-time Adoption of Indian Accounting Standards"	At page 6.17, Para on 'Deemed cost for PPE and intangible assets' has been amended
		At page 6.23, Para on 'Leases' has been amended

CONTENTS

DETAILED CONTENTS: MODULE – 1

CHAPTER 1: FRAMEWORK FOR PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

Contents:

CHAPTER-2: IND AS ON PRESENTATION OF ITEMS IN THE FINANCIAL STATEMENTS

Unit 1: Indian Accounting Standard 1: Presentation of Financial Statements

Contents:

Contents:

Unit 3: Indian Accounting Standard 7: Statement of Cash Flows

Contents:

CHAPTER 3 - IND AS 115 "REVENUE FROM CONTRACTS WITH CUSTOMERS"

Contents:

Contents:

Unit 2-Ind AS 10: "Events after the Reporting Period"

Contents:

Unit 3- Indian Accounting Standard 113 : Fair Value Measurement

Contents:

CHAPTER 5– OTHER INDIAN ACCOUNTING STANDARDS

Unit 1 – Ind AS 20: Accounting for Government Grants and Disclosure of Government Assistance

Contents:

Unit 2 – Ind AS 102: Share Based Payment

Contents:

CHAPTER 6– INDIAN ACCOUNTING STANDARD 101: FIRST-TIME ADOPTION OF IND AS

Contents:

CHAPTER 1

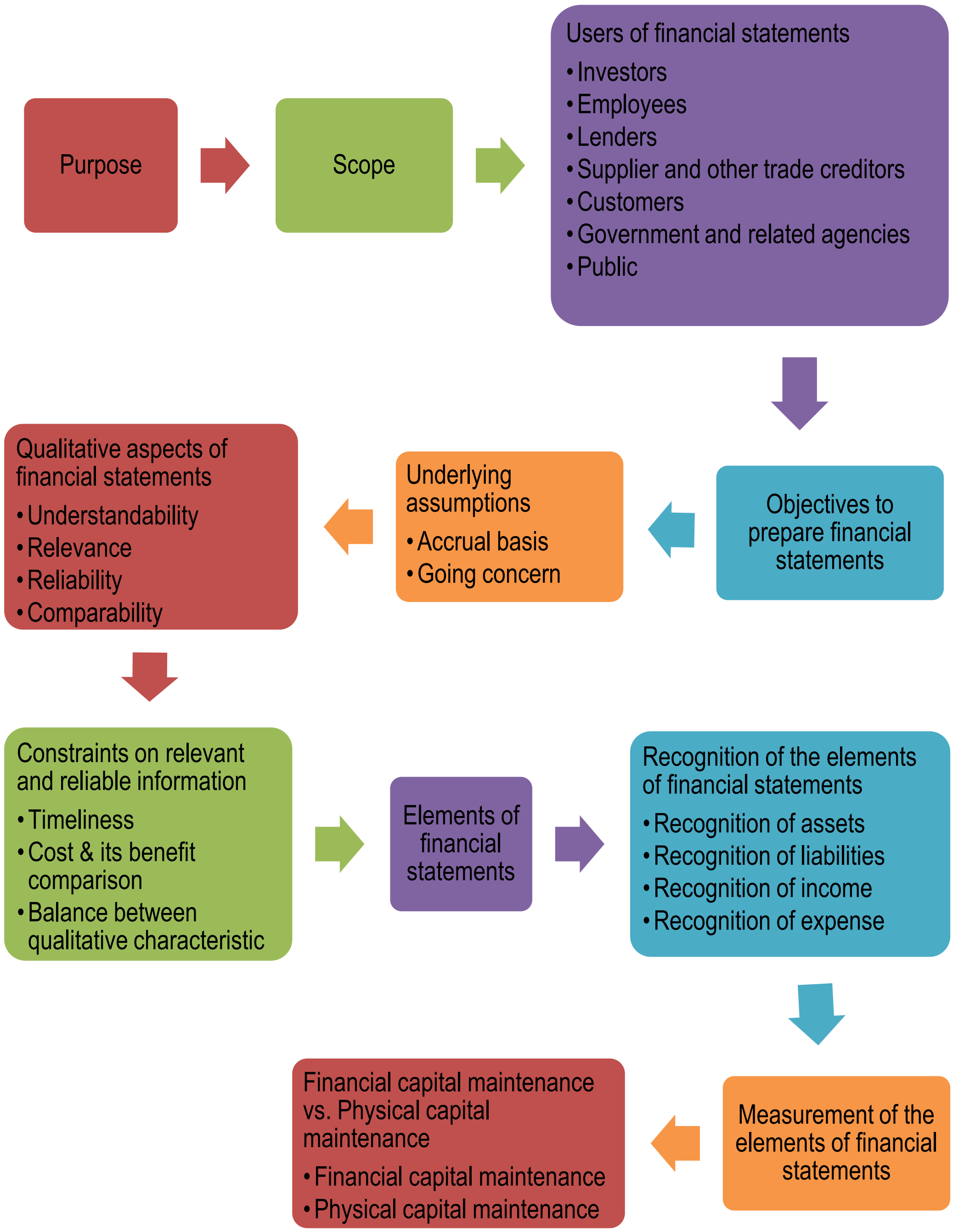
FRAMEWORK FOR PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

LEARNING OUTCOMES

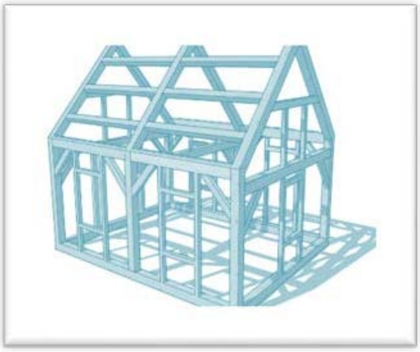
After studying this chapter, you would be able to:

- Understand the Framework and its role in accounting and interpreting the transactions
- Acknowledge the various users of financial statements
- Realise the constraints of relevant and reliable information
- Comprehend the underlying assumptions and qualitative aspects of the financial statements
- Differentiate between the two forms of capital

CHAPTER OVERVIEW



1. INTRODUCTION

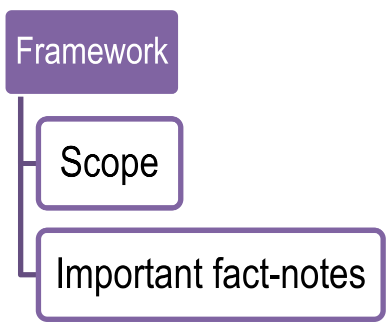


In general terms, a framework is a statement of generally accepted theoretical principles which form the frame of reference for a particular field of enquiry. In terms of financial reporting, these theoretical principles provide the basis for both the development of new reporting practices and the evaluation of existing ones. Since the financial reporting process is concerned with the provision of information that is useful in making business and economic decisions, a framework, in terms of financial reporting, will form the theoretical basis for determining which events should be accounted for, how they should be measured and how they should be communicated to the user.

Let's first understand the term Financial Statement and the reason why it is being prepared by all businesses irrespective of the nature of their business process.

Financial Statements are kind of a statement which reflects the performance of a business (business might be for profit or for non-profit) during a period (may be for a year, month, or quarter etc.) for which such statement is being prepared. Hence, the Financial Statements consist of presentation of numbers in such a way which reflects movements within specified category (assets, liability and Income/ expenses) with explanations/ notes (by way of notes to accounts & disclosures) to understand the methodology as adopted by an entity.

Now, the next question comes how the preparation of these Financial Statements can be regularized in such a way where all such Financial Statements shall have a consistency/ uniformity across the Industry (with few exceptions e.g. specially regulated financial statements). In addition, the user of these Financial Statements shall also have an assurance of complying basic framework with a consistent approach.



2. FRAMEWORK AND ITS PURPOSE

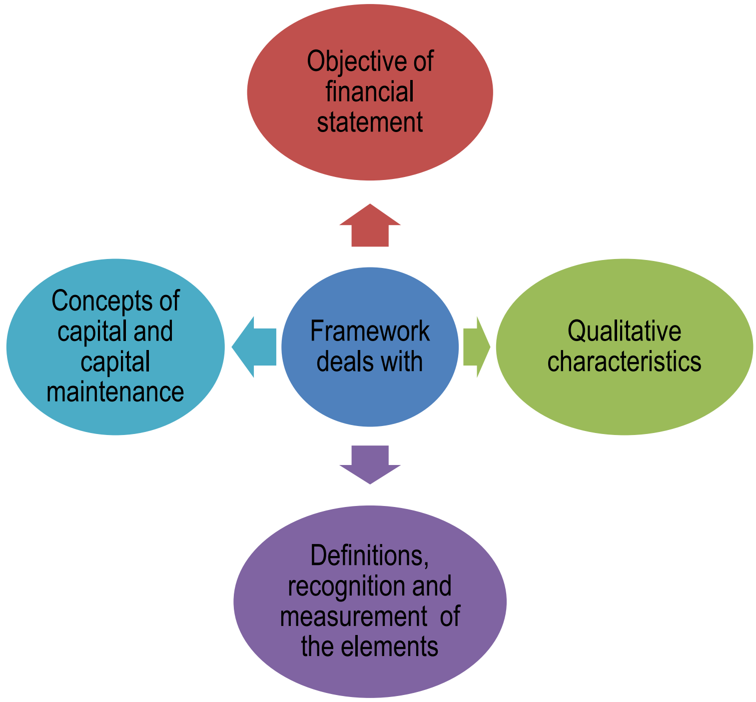
This Framework sets out the concepts that underlie the preparation and presentation of financial statements in accordance with the Indian Accounting Standards for external users. The purpose of the Framework is to:

- assist in the development of future Ind AS and review of existing Ind AS
- assist preparers of financial statements in applying Ind AS and in dealing with topics that have yet to form the subject of an Ind AS
- assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with Ind AS
- assist auditors in forming an opinion as to whether financial statements conform with Ind AS
- provide those who are interested in Ind AS with information about approach to their formulation, and
- assist in promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by Ind AS.

3. SCOPE OF THE "FRAMEWORK"

The framework works within a scope in which it is formulated or developed so that the user of such framework can understand its overall requirement while applying such framework on preparation of any financial statement. The framework deals with

- the objective of financial statements i.e. the purpose and the reason for which such financial statements are being prepared
- the qualitative characteristics that determine the usefulness of information in financial statements
- the definition, recognition and measurement of the elements from which financial statements are constructed e.g. assets, liabilities etc., and
- concepts of capital and capital maintenance.



The frameworks can be applied on all kinds of general purpose financial statements (including consolidated financial statements) irrespective of period for which it is being prepared (e.g. quarterly or annually).

Special purpose financial reports, for example, prospectuses and computations prepared for taxation purpose, are outside the scope of this Framework. Nevertheless, the Framework may be applied in the preparation of such special purpose reports where their requirements permit.

The Framework applies to the financial statements of all commercial, industrial and business reporting entities, whether in the public or the private sectors. The essence is to prepare financial statements by using this framework where the user relies solely on the information provided in the financial statements.

Financial statements do not, however, include such items as reports by directors, statements by the chairman, discussion and analysis by management and similar items that may be included in a financial or annual report.

The management of an entity has the primary responsibility for the preparation and presentation of the financial statements of the entity. The Framework does not deal with information outside the financial statements.

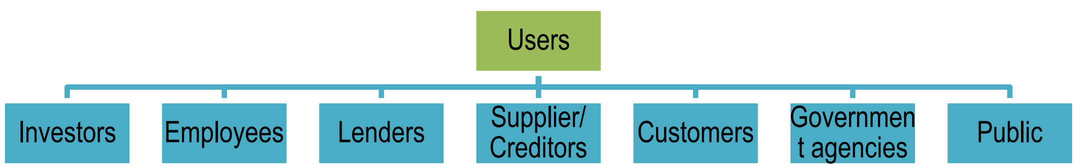
4. IMPORTANT FACTS-ABOUT "FRAMEWORK"

The framework provides a road map and approach which eventually will be considered as broad lines within which generally all accounting standards will be applied. However, following facts are worth to be noted:

- Since Framework is not an Indian Accounting Standard and hence does not define standards for any particular measurement or disclosure issue
- Existing standards might have some areas which contradicts (very rare in practice) with such Framework, then, requirement of the Indian Accounting Standards will prevail
- All the future Indian Accounting Standards or other pronouncement will be guided by the framework resulting in minimal conflicts
- Based on the experiences, the Framework will change to harmonise the Indian Accounting Standards across the industries.

5. USERS OF FINANCIAL STATEMENTS

The users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public. They use financial statements in order to satisfy some of their different needs for information. The users can be described broadly in the following category:



5.1 Investors

The providers of risk capital and their advisers are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information which enables them to assess the ability of the entity to pay dividends.

In reference to a listed entity, where stocks are being exchanged over a stock market, investor would require information about the performance or business activities so that any inherent risk can be evaluated. Any new or potential Investors would also analyse the activities of the business in order to pursue for investment in the stock of such entity. All such Investor might need useful & relevant information, which will enable them to conclude their action plan.

5.2 Employees

Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the entity to provide remuneration, retirement benefits and employment opportunities.

5.3 Lenders

Lenders are one of the key stakeholders which provide fuel to the business, i.e. money, which is ultimately returned back to the lenders in the nature of return, as the business generates cash flows in future. The repayment capacity of the entity will be assessed / analyzed based on the performance of the business and accordingly restructuring, discounting in future loans, re-negotiation can be planned.

5.4 Supplier and Other Trade Creditors

Suppliers and other trade creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an entity over a shorter period than lenders unless they are dependent upon the continuation of the entity as a major customer.

5.5 Customers

Customers are one of the major stakeholder which eventually drives growth of any business. To deal efficiently with them, would be a key to success of any business. If the performance of the business is in good shape, then there are more chances to negotiate better deal in favor of Company and vice-versa and the same can be done by analyzing financial statements of the Company.

5.6 Government and Related Agencies

Governments and their agencies are interested in the allocation of resources and, therefore, the activities of entities. They also require information in order to regulate the activities of entities, determine taxation policies and as the basis for national income and similar statistics.

5.7 Public

By and large, entities affect local public in variety of ways e.g. by generating employment, by providing different kind of social events, engaging local suppliers, developing infrastructure etc. Hence, the sufficient information in terms of trends and recent development from the financial statements would be important for them to understand future of the business.

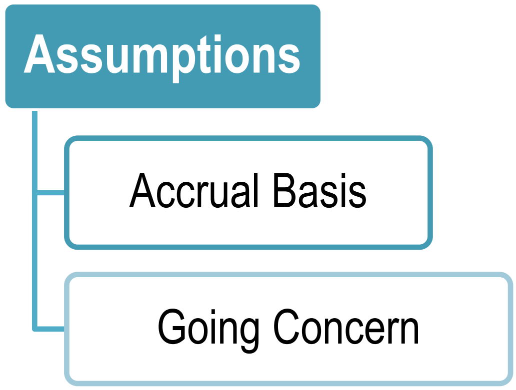
6. OBJECTIVES TO PREPARE FINANCIAL STATEMENTS

The objective of financial statements is to provide information about the financial position, performance and cash flows of an entity that is useful to a wide range of users in making economic decisions.

- Information about financial position i.e. balance sheet, statement of profit and loss, cash flows and related notes-
  - **Balance Sheet** comprises information about the economic resources controlled by the entity and its capacity in the past to modify these resources is useful in predicting the ability of the entity to generate cash and cash equivalents in the future. The balance sheet provides overall strength and capacity of a business at any point of time.
  - **Income Statement** comprises information about the performance of an entity, in particular its profitability, is required in order to assess potential changes in the economic resources that it is likely to control in the future.
  - **Cash flow Statements** will be useful in order to assess its investing, financing and operating activities during the reporting period. This information is useful in providing the user with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows,
  - The information that are being captured in balance sheet, statement of profit and loss, cash flows will have certain **explanatory notes/ information,** which are being reflected in the notes to accounts. The requirement of what to disclose specifically has been defined in different Accounting Standards, however there is nothing which precludes to make any additional information that might be useful for the user of such Financial Statements.
- Provide useful information to USER of the Financial Statement only reflects a financial information-
  - The information that reflects from the Financial Statements are purely based on financial information e.g. related to the monetary aspects of such transactions
  - Users of the Financial Statements might need to evaluate such other non- financial information which might be useful for them to analyze which normally will not be available in the Financial Statements.
- To know about the management style of working and their objectives going forward.

7. UNDERLYING ASSUMPTIONS

In order to prepare any financial statements, there are some basic assumption, which shall be followed.



7.1 Accrual Basis

Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.

Illustration 1

Entity A sells goods to Mr. X on November, 20X1 and received payments on January 31, 20X2. The entity follows December 31, 20X1 as its annual closing of financial statements. State how this business transaction should be accounted.

Solution

The goods have been sold off in the month of November, 20X1 and the payment has been received in the year 20X2 whereas the Entity A follows calendar year annual closing. Now, assuming that all recognition criteria (risk and rewards) has been met while selling off the goods in the month of November, 20X1, Entity A will recognize the sale in the Income statement with corresponding effect in accounts receivables for the year ending December 31, 20X1. This is called accrual accounting where the transaction is being recorded in the same year when it meets other recognition criteria and not when actual cash has been received/ paid.

Now, it is clear to understand that had this sale not been shown in the financial statement ending December 31, 20X1, the sale would have been understated by the same amount. Hence it has been recorded in the same period when the transaction has taken place and met recognition criteria as per applicable accounting standards.

*****

Financial statements prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.

7.2 Going Concern

The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

Example

Balance sheet of a trader on 31st March, 20X1 is given below:

Particulars	₹
Assets	
Non-current assets	
Property, Plant and Equipment	65,000
Current assets	
Inventories	30,000
Financial assets	
Trade receivables	20,000
Other asset	10,000
Cash and cash equivalents	5,000
	1,30,000
Equity and Liabilities	
Equity	
Share capital	60,000
Other Equity - Profit and Loss Account	25,000
Non-current liabilities	
10% Loan	35,000
Current liabilities	

Financial liabilities	
Trade payables	10,000
	1,30,000

Additional information:

(a) The remaining life of Property, Plant and Equipment is 5 years. The pattern of use of the asset is even. The net realisable value of Property, Plant and Equipment on 31.03.20X2 was ₹ 60,000.

(b) The trader's purchases and sales in 20X1-20X2 amounted to ₹ 4 lakh and ₹ 4.5 lakh respectively.

(c) The cost and net realisable value of inventories on 31.03.20X2 were ₹ 32,000 and ₹ 40,000 respectively.

(d) Employee benefit expenses for the year amounted to ₹ 14,900.

(e) Other asset is written off equally over 4 years.

(f) Trade receivables on 31.03.20X2 is ₹ 25,000, of which ₹ 2,000 is doubtful. Collection of another ₹ 4,000 depends on successful re-installation of certain product supplied to the customer.

(g) Cash balance on 31.03.20X2 is ₹ 37,100 before deduction of interest paid on loan.

(h) There is an early repayment penalty for the loan ₹ 2,500.

The Profit and Loss Accounts and Balance Sheets of the trader are shown below in two cases (i) assuming going concern (ii) not assuming going concern.

Profit and Loss Account for the year ended 31st March, 20X2

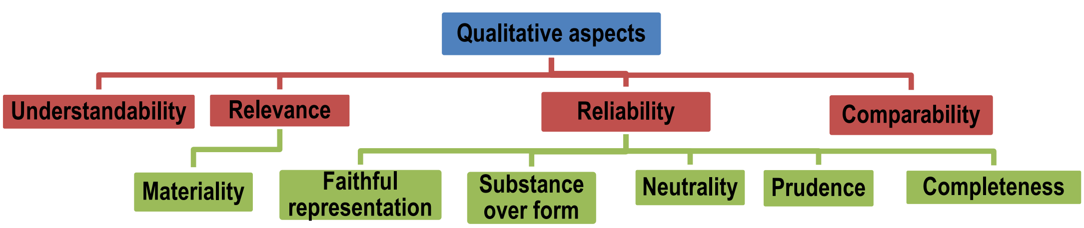
		Case (i)	Case (ii)
		₹	₹
Revenue from operations – Sales	(A)	4,50,000	4,50,000
Expenses			
Purchases		4,00,000	4,00,000
Changes in inventories		(2,000)	(10,000)
Employee benefit expenses		14,900	14,900
Finance cost		3,500	6,000
Depreciation and amortisation expenses		15,500	15,000
Other expenses - Provision for doubtful debts		2,000	6,000
Total Expenses	(B)	4,33,900	4,31,900
Profit for the period (A-B)		16,100	18,100

Balance Sheet as at 31st March, 20X2

Liabilities	Case (i) ₹	Case (ii) ₹
Assets		
Non-current assets		
Property, Plant and Equipment	52,000	60,000
Current Asset		
Inventories	32,000	40,000
Financial assets		
Trade receivables (less provision)	23,000	19,000
Other asset	7,500	Nil
Cash and cash equivalents (after interest paid on loan)	33,600	33,600
	1,48,100	1,52,600
Equity and Liabilities		
Equity		
Share Capital	60,000	60,000
Other Equity - Profit & Loss A/c	41,100	43,100
Non-current liabilities		
10% Loan	35,000	37,500
Current liabilities		
Trade payables	12,000	12,000
	1,48,100	1,52,600

8. QUALITATIVE ASPECTS OF FINANCIAL STATEMENTS

Usefulness of a financial statements is one of the key requirements as the information should be presented in such a way which makes sense for the user and should have consistency across the financial statements.



8.1 Understandability

An essential quality of the information provided in financial statements is that it is readily understandable by users who are assumed to have a reasonable knowledge of basic operations of the business. The information reflected in the financial statements should be drafted in a way which can easily provide its real meaning without getting into too much complexity. However, there may be areas which are required to be presented as important information for the users of the financial statements but being its complex nature, does not preclude the entity to present such information.

Example

An Oil & Gas Company maintaining well and exploration services has defined recognition of assets related to such exploration in the Financial Statements. It is expected that the user of such financial statement would know about the exploration activities and it is not expected to mention the meaning of these terms which otherwise is expected to be known by a person who uses such financial statements. However, if there is any change or any term which is specific to the entity, then the same should be properly explained e.g. any special contract and its related accounted treatment.

8.2 Relevance

The information that is being reflected in the financial statements must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

Example

1. A default by a customer who owes ₹ 1,000 to a Company having net assets of worth ₹ 10 million is not relevant to the decision making needs of users of the financial statements. However, if the amount of default is, say, ₹ 2 million, the information becomes relevant to the users as it may affect their view regarding the financial performance and position of the company.
2. A fire has been broken out at the end of the period but before issue of financial statements, could be relevant for the user to know about the estimated impact on future performance of the business even though the assessment of such loss was not possible to calculate, at the time of approving of such financials.

Relevance have some assessment pillars within which it can further be correlated.

8.2.1 Materiality

Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

Illustration 2

Entity A is having inventory amounting ₹ 100,000 in total with the details as below:

Spare parts	*₹ 30,000*
Finished goods	*₹ 25,000*
Work in progress	*₹ 40,000*
Tools	*₹ 5,000*
TOTAL	*₹ 1,00,000*

Materiality limit has been assessed ₹ 30,000 based on the management estimation pertaining to annual profit basis. What should be the presentation requirement under the "Materiality" criteria?

Solution

Entity A has estimated its materiality limit of ₹ 30,000 which suggests that everything which is more than this amount will be required to present separately, subject to its nature (nature means the components of inventory in this example). Hence, Entity needs to show Inventory as below by way of notes to account –

Work in progress	₹ 40,000
Spare parts	₹ 30,000
Finished goods & tools	₹ 30,000
TOTAL	₹ 1,00,000

Since, Work in progress and Spare parts are more than materiality limits, hence, they have been shown separately based on its defined separate nature whereas finished goods & tools have amount lower than materiality limits and same has been clubbed together.

*****

8.3 Reliability

The information which is relevant for the user of the financial statement but not reliable would eventually mislead the financial statements presentation and may influence the decision taken by the user of such financial statements. Information should be relevant and reliable as it is expected to have an error free and unbiased impact on the presentation of the financial statements.

Illustration 3

A legal case has been filed against A Ltd. However, expected outcome at the year-end cannot be evaluated. What would be relevant information and what would be reliable in it?

Solution

It may be inappropriate for the entity to recognise the full amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.

*****

8.3.1 Faithful Representation

It means that, unless the recognition criteria of any element of financial statement i.e. assets, liabilities, income or expenses etc. is fulfilled/met, there should not be any recognition of such elements in order to be faithful to the users who actually rely on information reflecting from the financial statements.

Examples

1. If there is a revenue which is to be recognized as per the relevant accounting standard but if the amount can't be ascertained then if an entity still does so, it will be unfaithful representation of the information.
2. There could be a recoverability of debtors in which management provides a written communication to ensure about expectation of recovery in full, however, the chances are remote then this would be treated as unfaithful representation of debtor's amount in the financial statements.

8.3.2 Substance over Form

If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form.

Illustration 4

An asset has been sold from A Ltd. to Mr. X and immediately after this transaction, Mr. X has leased out the same to A Ltd. What would be the correct form to record the transaction using concept of "substance over form"?

Solution

The asset has been actually transferred to pass on legal title of the asset to Mr. X and convert that into a lease asset. Hence, in substance, the economic benefit is still being enjoyed by A Ltd. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if indeed there was a transaction).

*****

8.3.3 Neutrality

The information contained in the financial statements should be free from any bias i.e. neutral and there should not be any kind of influence which makes the information undesirable or undisclosed. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

8.3.4 Prudence

Often certain estimates are being required to be made by the preparer of the financial statements which may or may not be 100% correct. However, one should use its prudence which is without any biasness and best possible action to reach to the conclusion in such cases. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability.

Example

Receivables recoveries are being assessed based on some estimation by the management and to arrive to such estimation for provision for bad debts, there must be a prudent action which is required to identify the recoverability of the debtors. The prudence could be used by meeting personally with the debtors, reviewing correspondences with the debtors, visiting the business premises to ensure the health of debtor's business before it is concluded for making any provision.

8.3.5 Completeness

The financial statements should be prepared to ensure that it covers all the transactions that has be done during the period and control must be establish to ensure its completeness of transactions without having any left out entries/ transactions which purposely/ by error are recorded in next period or not recorded at all. It may be due to wrong classification of nature of the transactions as well.

Example

Some direct costs booked into general overheads, has overstated the gross margin, which otherwise should have been booked as direct costs. There should be some check and balances to ensure that all elements reflected in the financial statements are complete in all aspects.

8.4 Comparability

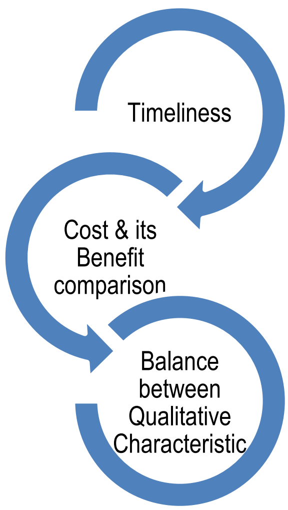
Users must be able to compare the financial statements of an entity through time in order to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different entities in order to evaluate their relative financial position, performance and cash flows. Hence, the measurement and display of the financial effect of like transactions and other events must be carried out in a consistent way throughout an entity and over time for that entity and in a consistent way for different entities.

Example

There are certain expenses that have been grouped under cost of sales in the previous year, whereas, in the current year, the amount has been shown under other general expenses without regrouping the previous year numbers which eventually distort the comparison of amounts of cost of sales & general expenses on yearly basis.

Users wish to compare the financial position, performance and cash flows of an entity over time, it is important that the financial statements show corresponding information for the preceding periods. Information which is necessary to provide details relating to any change in accounting policy should be clearly mentioned with impact of such change for the current and previous period.

9. CONSTRAINTS ON RELEVANT AND RELIABLE INFORMATION



9.1 Timeliness

It is one of the common objective to provide useful and reliable financial reports to the user but it should never be at the cost of time. If there are certain situations where the relevant inputs are taking too much of time to retrieve, then it will not serve a meaningful purpose by justifying a time that has been spent on the same. However, time constraint should not preclude the management to get rid with reliable inputs as required to be presented to ensure faithful representation.

9.2 Cost and its Benefit Comparison

At the same time, if information requires too much efforts in terms of utilization of resources and efforts comparing to its benefit to the user of such financial statements, then the same should be analyze carefully by the management for consideration.

Undue efforts and cost will fade its utility and will not make any sense to user of such financial statements.

Example

There is an additional verification (as part of normal policy to be applied to all debtors) which has been requested by the management for some small debtor which are totally immaterial. The verification was intended by visiting customer business place which are far from the Company Head office and would take atleast 2 working day to complete the process with a significant amount of expense on travel. The management should perform such procedure by using some other alternative procedure to avoid cost which will not make any sense to substantiate an immaterial customer balance.

9.3 Balance between Qualitative Characteristic

There should be a balance between the qualitative information provided in financial statements and its objective. Over information will not serve any purpose and hence, a balance between the qualitative information and its objective should be made.

10. ELEMENTS OF FINANCIAL STATEMENTS

Broadly, a statement of financial position or balance sheet comprises three elements viz. Asset, Liability and Equity which can be described as below –

ASSETS – "An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity"

The Standard emphasis on future economic benefits to flow to the entity is not only related to its legal form but it should also be assessed in line of substance over form and accordingly, an asset should be recognized.

Example : Control over Asset (substance over form)

Due to some legal constraints in the country, Entity A holds some assets on behalf of Company B which are being used/ directed by the Company B itself, without any interfere by the Company A. All production benefits will exclusively be used by Company B.

Merely holding an asset as its legal owner will not satisfy recognition criteria for an asset, hence, Asset will be recognized in the books of Company B as all the future economic benefit which is expected to flow to Company B only.

Example: Economic Benefits Flow to the Entity

A Pharma Company incurs some expenditure which is expensed off in order to develop its new drug. The future economic benefits will not have expected to flow to the Pharma Company because research phase itself does not establish any rationale to provide any kind of benefit which will flow to the Company at this stage (as per the relevant accounting standards).

Hence all expenditures will not be eligible to recognize as asset unless its benefits are expected to flow to the entity in future.

Example : Results from Past Transactions

An entity expected to purchase some asset in future which will increase profitability for the Company will not satisfy the definition of the Asset. Since the transaction/ expenses incurred should result from past event and not something which belongs to any future course of action, an asset will not be recognized based on any future course of action.

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

Some of the notable words as per the definition are – *Liability is a present obligation arises from past events* which essentially means there should not be any future expected obligation on which a liability would be created. In other words, there should be some form of legal binding agreement (although it is not essential to have explicit legal agreement) against which future outflow is expected from the entity. For example, purchase contracts where an entity has received the goods and therefore, is legally bound to make a payment in future point of time as per the agreed terms.

Example : Present Obligation based on Past Events

An Entity has got an information about the requirement to implement new taxation system based on proposed change in legislation in the country. The amount that is expected to outflow from the entity is not based on past events and hence this cannot be treated as present obligation.

Example : Additional Custom Duty Rate Changes

An import has been done in the past on which there is change in additional duty, as announced by the government of that country, which is to be paid in future. Since, the goods have been imported in the past period and new additional custom duty obligation arises because of this past event, hence this will result in a present obligation based on past events and therefore, a liability will be created.

Settlement of such liability could be in cash, transfer of other assets, conversion of obligation into equity etc.

There are liabilities, where timing and amount are not certain, but meets the recognition criteria, then the amounts are being estimated using some techniques and shown as provisions.

EQUITY- Equity is the residual interest in the assets of the entity after deducting all its liabilities.

In simplest form, an equity is a difference between total assets and total liability which shows initial cash/ capital that was brought into and additional performance in terms of profit or loss of the Company since inception.

Equity, however, is divided in many sub-parts e.g. security premium, reserves fund, retained earning etc. The segregation will eventually describe the capacity of an entity to pay dividends in the future. The existence of some funds within the equity sometimes are required by the law and it provides an insight to the user of financial statements.

Equity will be an amount which is finally distributed among its shareholder in case the business closed down. It reflects the value of the assets and corresponding liabilities that are being shown in the financial statements. However, it should not be confused with the selling price which would eventually be reflected once business is being disposed of. Some accounting standards, however, requires to measure such assets, which are to be disposed of in near future, at its fair value.

INCOME - Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an entity.

Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity. Gains are often reported net of related expenses.

EXPENSES - Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the entity. Expenses that arise in the course of the ordinary activities of the entity include, for example, cost of sales, wages and depreciation.

Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the entity

Expense is something which reduces economic benefits during the reporting period.

11. RECOGNITION OF THE ELEMENTS OF FINANCIAL STATEMENTS

Once we understood the definition of the elements of financial statements, let us now understand the recognition criteria of such elements. In other words, it provides a direction when such elements would be eligible for recognition. Hence, all items which meet the definition of the elements will not automatically be eligible for recognition.

Let us understand the general criteria to recognize the elements –

An Item which satisfies the definition of an element should be recognised only if

- it is probable that any future economic benefit associated with the item will flow to or from the entity; and
- the item has a cost or value that can be measured with reliability.

A. Understanding – Probability of future economic benefits

Uncertainty will be inherent in an environment of any entity and it's a matter of judgment to assess whether it is probable that economic benefit will inflow/ outflow from/to the Company.

Probable has not been defined by the framework, however, certain accounting standards defines probable as "more likely than not" which means there are more chances of happening the inflow/ outflow rather it does not. Hence remote probability will not suffice in order to recognize an element in financial statement.

There are certain assets which are contingent in nature and can never be recognized in the financial statements because benefit inflow to the company is remote and might never be realized.

Example

An Insurance claim which is likely to be finalized will not be recognized as an asset unless there is a probability of success which ideally should be more likely than not. Same rule will apply to the Contingent liability and hence cannot recognize as a liability.

B. Understanding – Reliability to measure cost or value

There could be a situation where an item meets the definition and other recognition criteria as an asset but there is no clarity or reasonable estimate, which can be made in order to arrive its recognition amount to be recognized.

Example

There are some contracts which are currently under work- in progress where it is not reasonably possible to arrive at estimated cost incurred and hence, it would be not be viable to recognize income/ assets, as the case may be. Measurement of the cost or value should be done reliably otherwise it will not provide a true view to the users of the financial statements.

11.1 Recognition of Assets

An item will be recognized as an asset in the Balance sheet when it is probable that the future economic benefit will flow to the entity and the asset has a cost or value that can be measured reliably.

Example

A legal case has been filed against the entity and there was an order which was yet to be received at the end of closing of the financial statements. There was no reliable estimation that could be made to arrive to an amount which is expected to inflow to the Company at the end of year and hence there is no recognition of asset during that period of financial statements. However, in subsequent periods, once the amount of such claim can be estimated reliably then the recognition of asset can be established.

It is clear that the non-recognition of an asset does not mean that the expectation of economic benefit from the expenditure was misguided rather it is just a deferment of period till the cost/ value of the asset can be reliably estimated.

11.2 Recognition of Liabilities

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

Example

A Company has sold some goods to Mr. X in the current year and found that there were some defects in the goods supplied. Mr. X has asked for damage/ repair reimbursement from the Company. At the year end, the Company made an assessment using its past experiences in similar kind of condition and made a provision in the books at the year end. Since the Company A has agreed to compensate Mr. X as a matter of custom of the business relationship, it is certain that the economic benefit will out flow from the company because of past event of selling off the goods. Further, the Company was able to estimate the amount of provision which was based on its past experience and hence, a liability has been recognized.

11.3 Recognition of Income

Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably.

Example

A construction company has done some construction activities during the current year and at the end of the year, it was found that the proportionate work that has been done, is not identifiable and there is no history of similar kind of work that had ever been performed by the entity. Hence, if the value of the revenue cannot be estimated reliably, then, no revenue will be recognized in the period. However, it will be recognized when the estimation can be reliably measured in one or more subsequent periods.

11.4 Recognition of Expenses

Expenses are recognized in the statement of profit and loss when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.

Following are some applications approach relating to the expenses:

- Matching costs with revenue generated

Example

A Manufacturing Company captures all cost which would have been incurred against the inventory that has been produced during the period. This concept is called Matching concept. However, the expenses will only be recognized in this case when it meets recognition criteria as per the definition.

- Economic benefit to arise in one or more accounting periods

Example

A maintenance contract has been signed for repairing the tools which are being used under the production process. The contract has been made for 3 years. There are no limits/ reference in the contract which defines the number of tools that can be repaired. However, the maintenance contract amount is to be paid on yearly basis even when there are no repairs of tool. In this situation, there is no other basis to allocate these expenses over the period but to allocate on straight line basis over the period, hence the maintenance expense will be equally spread over the 3 year period irrespective of its actual use in repairing the tools.

- Immediate recognition of expense

Example

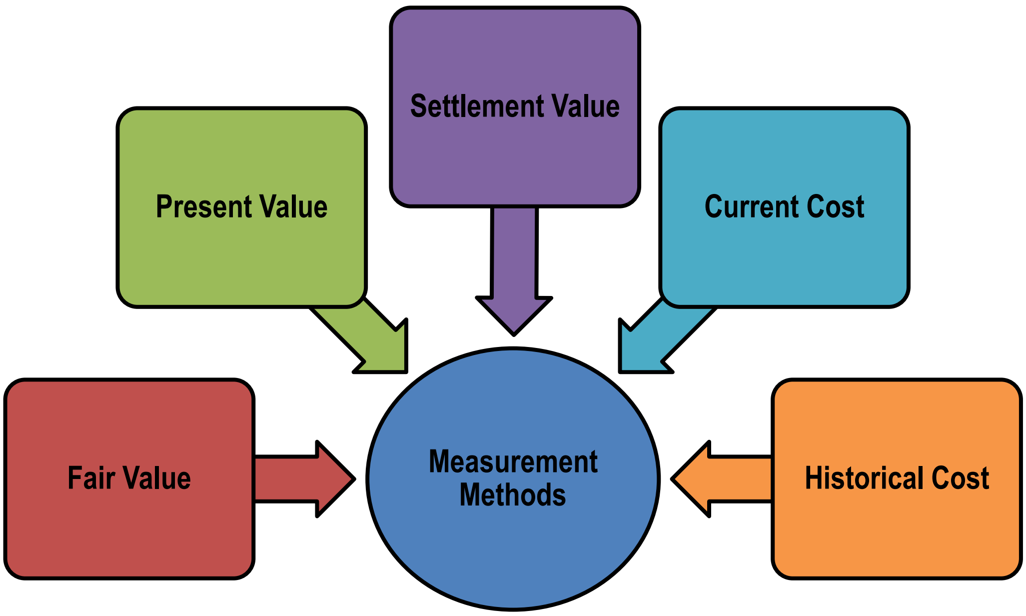
A company has incurred an amount of ₹ 1,00,000 on a land surfacing and at the later part of the year, it was found that the title of land was not transferred in the name of the Company due to some legal restrictions. Hence, the deal to purchase a land will be cancelled. Now, the amount that has been incurred relating to surfacing the land will have no future economic value and hence there is no allocation of expenses for any future benefits. Hence this cost of ₹ 1,00,000 will be expensed out immediately in full.

- Recognition of a liability with an expenses

Example

A Company has sold some product with warranty for next 2 years. The Company has history of making such repairs and based on the estimate, has made a provision for next 2 years. The said recognition of liability will have corresponding expenses over the period of such provision.

12. MEASUREMENT OF THE ELEMENTS OF FINANCIAL STATEMENTS



As the name suggest, the measurement refers to the amount/ numeric which needs to be recognised. There could be several measurement methods as defined/ required by respective accounting standards. Brief descriptons of the same can be referred below:

- **Historical Cost** – means the transaction value that has been given or received at the time of recognising such element in the financial statements togther with all attributable costs incurred or expected to be incurred.

Example

Property, Plant and Equipment is capatalized considering all direct expenses that have been incurred in order to bring the asset into its present condition (subject to other costs).

- **Current Cost** – means the value of an element which has been recognised at its recent paid/ received price.

Example

A liability which is to be paid in short period will be recognised at current cost rather than discounted value (which is used when the liability is to be paid in more than one year).

- **Settlement Value**- means the value of an element which are required to be recognised at the value which is to be received/ paid by selling or for immediate settlement.

Example

An Asset held for sale or liability which is to be settled in recent future.

- **Present Value** - Present value means present discounted value of the future net cash inflows / outflows that the item is expected to generate / settle in the normal course of business. The calculated value will represent its current value.

Example

A liability to be paid after 20 years will be discounted by using incremental borrowing rate of the entity to calculate the present value of the liability.

- **Fair Value** – means an amount at which asset / liability could be exchanged / settled, between knowledgeable, willing parties in an arm's length transaction.

Example

Equity investment listed at stock market where it has substantial exchange every day could be used as the fair value of the Investment.

13. FINANCIAL CAPITAL MAINTENANCE VS. PHYSICAL CAPITAL MAINTENANCE

A. Financial Capital maintenance

Under this concept, a profit is earned only if the financial amount of the net assets at the end of the period exceeds the financial amount of net assets at the beginning of the period, after excluding any distribution to, and contribution from, owners during the period.

B. Physical Capital maintenance

Under this conept, a profit is earned only if the physical productive or operating capability of the entity at the the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

13.1 Major differences between Physical Capital & Financial Capital

- The physical capital maintenance concept requires the adoption of the current cost basis as measurement whereas financial capital maintenance concept does not require the use of a particular basis of measuerment.
- The principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the entity. In general terms, an entity has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount over and above that required to maintain the capital at the beginning of the period is profit.
- Financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit.
- Under the concept of physical capital maintenance when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the entity are viewed as changes in the measurement of the physical productive capacity of the entity; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.

This Framework is applicable to wide varity of financial statements based on the selection of measurement as per relevent accounting standards. The overall objective is to provide the framework so that presentation requirements and principals remains consistent. However, the framework supplements the requirements of various accounting standards and does not intend to override any of such specific guidance available in any accounting stanrads.

Example A

A trader commenced business on 01/01/20X1 with ₹ 12,000 represented by 6,000 units of a certain product at ₹ 2 per unit. During the year 20X1 he sold these units at ₹ 3 per unit and had withdrawn ₹ 6,000. Thus:

Opening Equity = ₹ 12,000 represented by 6,000 units at ₹ 2 per unit.

Closing Equity = ₹ 12,000 (₹ 18,000 – ₹ 6,000) represented entirely by cash.

Retained Profit = ₹ 12,000 – ₹ 12,000 = Nil

The trader can start year 20X2 by purchasing 6,000 units at ₹ 2 per unit once again for selling them at ₹ 3 per unit. The whole process can repeat endlessly if there is no change in purchase price of the product.

Example B

In the previous example A, suppose that the average price indices at the beginning and at the end of year are 100 and 120 respectively.

Opening Equity = ₹ 12,000 represented by 6,000 units at ₹ 2 per unit.

Opening equity at closing price = (₹ 12,000 / 100) x 120 = ₹ 14,400 (6,000 x ₹ 2.40)

Closing Equity at closing price

= ₹ 12,000 (₹ 18,000 – ₹ 6,000) represented entirely by cash.

Retained Profit = ₹ 12,000 – ₹ 14,400 = (-) ₹ 2,400

The negative retained profit indicates that the trader has failed to maintain his capital. The available fund ₹ 12,000 is not sufficient to buy 6,000 units again at increased price ₹ 2.40 per unit. In fact, he should have restricted his drawings to ₹ 3,600 (₹ 6,000 – ₹ 2,400).

Had the trader withdrawn ₹ 3,600 instead of ₹ 6,000, he would have left with ₹ 14,400, the fund required to buy 6,000 units at ₹ 2.40 per unit.

Example C (Physical Capital Maintenance)

In the previous example A, suppose that the price of the product at the end of year is ₹ 2.50 per unit. In other words, the specific price index applicable to the product is 125.

Current cost of opening stock	= (₹ 12,000 / 100) x 125 = 6,000 x ₹ 2.50 = ₹ 15,000
Closing cash after adjustment of stock at current costs	= ₹ 9,000 [(₹ 6,000 x 2.5) – ₹ 6,000]
Opening equity at closing current costs	= ₹ 15,000
Closing equity at closing current costs	= ₹ 9,000
Retained Profit	= ₹ 9,000 – ₹ 15,000 = (₹ 6,000)

The negative retained profit indicates that the trader has failed to maintain his capital. The available fund ₹ 9,000 is not sufficient to buy 6,000 units again at increased price ₹ 2.50 per unit. There should not be any drawings in the year.

Had the trader withdrawn nothing during the year instead of ₹ 6,000, he would have left with ₹ 15,000, the fund required to buy 6,000 units at ₹ 2.50 per unit.

Capital maintenance can be computed under all three bases as shown below:

Financial Capital Maintenance at historical costs

	₹	₹
Closing capital (At historical cost)		12,000
Less: Capital to be maintained		
Opening capital (At historical cost)	12,000	
Introduction (At historical cost)	Nil	(12,000)
Retained profit		Nil

Financial Capital Maintenance at current purchasing power

	₹	₹
Closing capital (At closing price)		12,000
Less: Capital to be maintained		
Opening capital (At closing price)	14,400	
Introduction (At closing price)	Nil	(14,400)
Retained profit		(2,400)

Physical Capital Maintenance

	₹	₹
Closing capital (At current cost)		9,000
Less: Capital to be maintained		
Opening capital (At current cost)	15,000	
Introduction (At current cost)	Nil	(15,000)
Retained profit		(6,000)

TEST YOUR KNOWLEDGE

Question

1. There should be a balance between the qualitative information provided in the financial statements and its objective. Comment

CHAPTER 2

IND AS ON PRESENTATION OF ITEMS IN THE FINANCIAL STATEMENTS

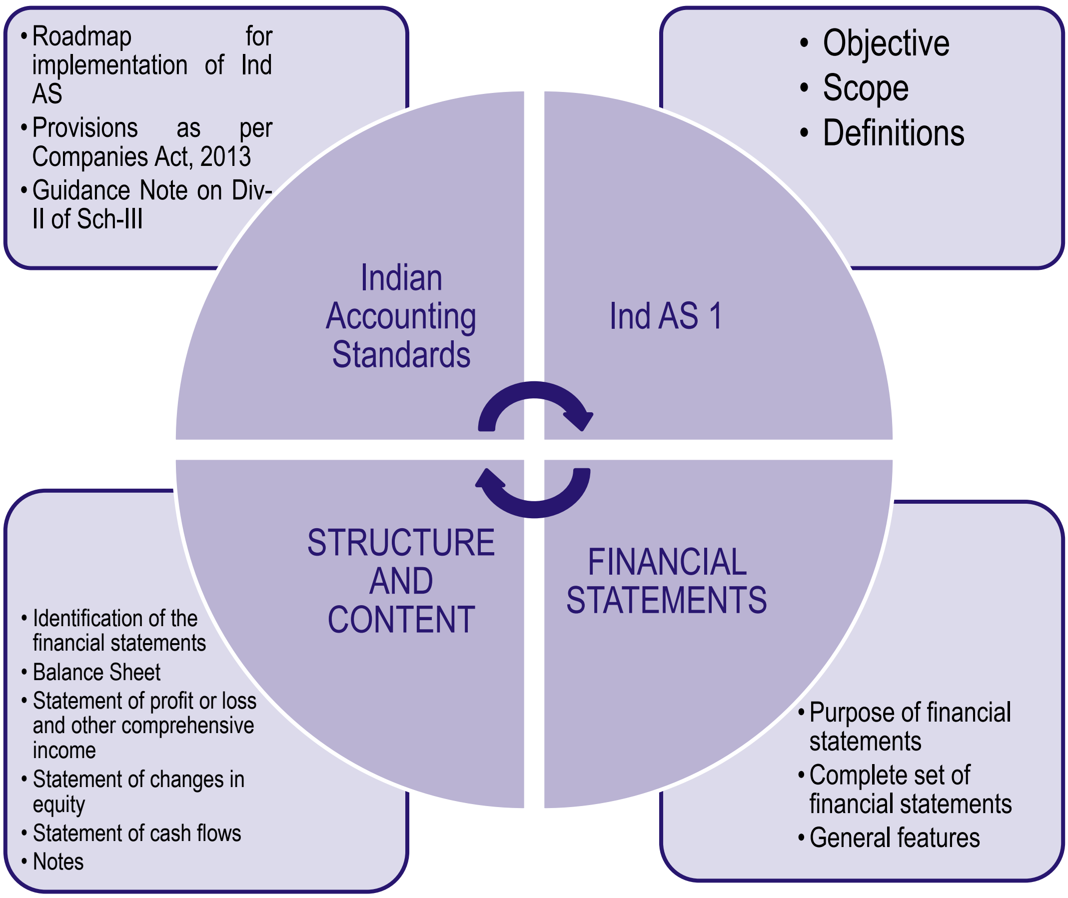
UNIT 1 : INDIAN ACCOUNTING STANDARD 1 : PRESENTATION OF FINANCIAL STATEMENTS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand what are Indian Accounting Standards
- Appreciate the roadmap issued by various authorities for implementation of Ind AS
- Explain the carve outs and carve ins in Ind AS
- Figure out the formats applicable for Ind AS compliant financial statements and its peculiar features
- Examine the scope and objective of Ind AS 1 and also define the relevant terms used in Ind AS 1
- Understand overall requirements for presentations of Financial Statements
- Identify the various components of Financial Statements
- Describe the disclosure requirements to be made
- Examine the significant differences in Ind AS 1 vis-à-vis AS 1
- Appreciate the carve out in Ind AS 1 from IAS 1 and reason thereof.

UNIT OVERVIEW



1.1 INTRODUCTION TO INDIAN ACCOUNTING STANDARD (IND AS)

In the present era of globalisation and liberalisation, the world has become an economic village. The globalisation of the business world, the attendant structures and the regulations, which support it, as well as the development of e-commerce make it imperative to have a single globally accepted financial reporting system. A number of multi-national companies are establishing their businesses in various countries with emerging economies and vice versa. The entities in emerging economies are increasingly accessing the global markets to fulfill their capital needs by getting their securities listed on the stock exchanges outside their country. Capital markets are, thus, becoming integrated consistent with this world-wide trend. More and more Indian companies are being listed on overseas stock exchanges. The use of different accounting frameworks in different countries, which require inconsistent treatment and presentation of the same underlying economic transactions, creates confusion for users of financial statements. This confusion leads to inefficiency in capital markets across the world. Therefore, increasing complexity of business transactions and globalisation of capital markets call for a single set of high quality accounting standards.

High standards of financial reporting underpin the trust investors place in financial and non-financial information. Thus, the case for a single set of globally accepted accounting standards has prompted many countries to pursue either adoption or convergence of national accounting standards with IFRS.

International Financial Reporting Standards (IFRS) are considered a "principles-based" set of standards. In fact, they establish broad rules rather than dictating specific treatments. Every major nation is moving toward adopting them to some extent. Large number of authorities requires public companies to use IFRS for stock-exchange listing purposes, and in addition, banks, insurance companies and stock exchanges may use them for their statutorily required reports. So over the next few years, thousands of companies will adopt the international financial reporting standards while preparing their financial statements.

1.1.1 Government of India - Commitment to IFRS Converged Ind AS

Consistent, comparable and understandable financial reporting is essential to develop a robust economy. With a view to achieve international benchmarks of financial reporting, the Institute of Chartered Accountants of India (ICAI), as a proactive role in accounting, set out to introduce Indian Accounting Standards (Ind AS) converged with the International Financial Reporting Standards (IFRS). This endeavour of the ICAI is supported by the Government of India.

Initially Ind AS were expected to be implemented from the year 2011. However, keeping in view the fact that certain issues including tax issues were still to be addressed, the Ministry of Corporate Affairs decided to postpone the date of implementation of Ind AS.

In July 2014, the Finance Minister of India at that time, Shri Arun Jaitely ji, in his Budget Speech, announced an urgency to converge the existing accounting standards with the International Financial Reporting Standards (IFRS) through adoption of the new Indian Accounting Standards (Ind AS) by the Indian companies from the financial year 2015-16 voluntarily and from the financial year 2016-17 on a mandatory basis.

Pursuant to the above announcement, various steps have been taken to facilitate the implementation of IFRS-converged Indian Accounting Standards (Ind AS). Moving in this direction, the Ministry of Corporate Affairs (MCA) has issued the Companies (Indian Accounting Standards) Rules, 2015 vide Notification dated February 16, 2015 covering the revised roadmap of implementation of Ind AS for companies other than Banking companies, Insurance Companies and NBFCs and Indian Accounting Standards (Ind AS). As per the Notification, Indian Accounting Standards (Ind AS) converged with International Financial Reporting Standards (IFRS) shall be implemented on voluntary basis from 1st April, 2015 and mandatorily from 1st April, 2016.

1.2 WHAT ARE INDIAN ACCOUNTING STANDARDS (IND AS)?

Indian Accounting Standards (Ind-AS) are the International Financial Reporting Standards (IFRS) converged standards issued by the Central Government of India under the supervision and control of Accounting Standards Board (ASB) of ICAI and in consultation with National Financial Reporting Authority (NFRA).

ASB is a committee under Institute of Chartered Accountants of India (ICAI) which consists of representatives from government department, academicians, other professional bodies viz. ICSI, ICAI, representatives from ASSOCHAM, CII, FICCI, etc. National Financial Reporting Authority (NFRA) recommends these standards to the Ministry of Corporate Affairs (MCA). MCA has to spell out the accounting standards applicable for companies in India.

Ind AS are named and numbered in the same way as the corresponding International Financial Reporting Standards (IFRS).

1.3 WHAT ARE CARVE OUTS/INS IN IND AS?

The Government of India in consultation with the ICAI decided to converge and not to adopt IFRS issued by the IASB. The decision of convergence rather than adoption was taken after the detailed analysis of IFRS requirements and extensive discussion with various stakeholders.

Accordingly, while formulating IFRS-converged Indian Accounting Standards (Ind AS), efforts have been made to keep these Standards, as far as possible, in line with the corresponding IAS/IFRS and departures have been made where considered absolutely essential. These changes have been made considering various factors, such as

- Various terminology related changes have been made to make it consistent with the terminology used in law, e.g., 'statement of profit and loss' in place of 'statement of comprehensive income' and 'balance sheet' in place of 'statement of financial position'.
- Removal of options in accounting principles and practices in Ind AS vis-a-vis IFRS, have been made to maintain consistency and comparability of the financial statements to be prepared by following Ind AS. However, these changes will **not result into carve outs.**
- Certain changes have been made considering the economic environment of the country, which is different as compared to the economic environment presumed to be in existence by IFRS. These differences are due to differences in application of accounting principles and practices and economic conditions prevailing in India. These differences which are in deviation to the accounting principles and practices stated in IFRS, are commonly known as **'Carve-outs'.**

Note: In Ind AS 103 "Business Combination", an additional guidance on "Accounting of Business Combinations of Entities under Common Control" is given which is over and above what is given in IFRS. This is termed as 'Carve-in'.

1.4 ROADMAP FOR IMPLEMENTATION OF THE INDIAN ACCOUNTING STANDARDS (IND AS)

1.4.1 For Companies other than banks, NBFCs and Insurance Companies

Phase I	**1st April 2015 or thereafter: Voluntary Basis for all companies (with Comparatives)**	
	1st April 2016: Mandatory Basis	
	(a)	Companies listed / in process of listing on Stock Exchanges in India or Outside India having net worth $\geq$ ₹ 500 crore
	(b)	Unlisted Companies having net worth $\geq$ ₹ 500 crore
	(c)	Parent, Subsidiary, Associate and Joint venture of above
Phase II	**1st April 2017: Mandatory Basis**	
	(a)	All companies which are listed/or in process of listing inside or outside India on Stock Exchanges not covered in Phase I (other than companies listed on SME Exchanges)
	(b)	Unlisted companies having net worth of ₹ 250 crore or more
	(c)	Parent, Subsidiary, Associate and Joint venture of above

- Companies listed on SME exchange not required to apply Ind AS.
- Once Ind AS are applicable, an entity shall be required to follow the Ind AS for all the subsequent financial statements.

- Companies not covered by the above roadmap shall continue to apply existing Accounting Standards notified in Companies (Accounting Standards) Rules, 2006.

1.4.2 For Scheduled Commercial Banks (Excluding RRBs), Insurers/Insurance Companies and Non-Banking Financial Companies (NBFC's)

Non-Banking Financial Companies (NBFC's)	
Phase I:	From 1st April, 2018 (with comparatives)
	▪ NBFCs (whether listed or unlisted) having net worth ₹ 500 crore or more
	▪ Holding, Subsidiary, JV and Associate companies of above NBFC other than those already covered under corporate roadmap shall also apply from said date
Phase II:	From 1st April, 2019 (with comparatives)
	▪ NBFCs whose equity and/or debt securities are listed or are in the process of listing on any stock exchange in India or outside India and having net worth less than 500 crore
	▪ NBFCs that are unlisted having net worth ₹ 250 crore or more but less ₹ 500 crore
	▪ Holding, Subsidiary, JV and Associate companies of above other than those already covered under corporate roadmap shall also apply from said date

- Applicable for both Consolidated and Individual Financial Statements
- NBFC having net worth below ₹ 250 crore shall not apply Ind AS.
- Adoption of Ind AS is allowed only when required as per the roadmap.
- Voluntary adoption of Ind AS is not allowed.

Scheduled Commercial banks (excluding RRB's)

- Scheduled Commercial Banks (SCBs) excluding Regional Rural Banks (RRBs) were initially required to implement Indian Accounting Standards (Ind AS) from 1 April 2018. RBI vide a press release dated 5 April 2018, deferred the implementation of Ind AS by one year i.e. from 1 April 2019. However, later on it deferred the Ind AS implementation till further notice RBI through a notification dated 22 March 2019.

Insurers/Insurance companies

- From 1st April, 2021 (with comparatives):
  - ♦ Holding, subsidiary, JV and Associates companies of insurers/insurance companies shall also apply from the said date irrespective of it being covered under corporate roadmap.

- Applicable for both Consolidated and individual Financial Statements.

1.5 DIVISION II OF THE SCHEDULE III TO THE COMPANIES ACT, 2013

The Ministry of Corporate Affairs vide its notification dated 6th April, 2016 notified amendments to Schedule III to the Companies Act, 2013 thereby inserting Division II to Schedule III for preparation of financial statements by those entities who have to comply with Indian Accounting Standards (Ind AS). Later on, MCA on March, 2018 notified Division III to Schedule III prescribing the format for NBFCs financial statements. Now as per the Companies Act, 2013, Schedule III, there are three divisions namely-

1. Division I, which is applicable to a company whose financial statements are required to comply with the accounting standards.
2. Division II, which is applicable to a company whose financial statements are drawn up in compliance with Ind AS.
3. Division III, which is applicable to Non-Banking Finance Companies whose financial statements are drawn up in compliance with Ind AS.

Points which merits consideration

- All companies that prepare, either voluntarily or mandatorily, Financial Statements in compliance with the Companies (Indian Accounting Standards) Rules, 2015 should consider Ind AS Schedule III (Division II) as well as the Guidance Note on Division II of Schedule III to the Companies Act, 2013.
- The requirements of Ind AS Schedule III, do not apply to companies as referred to in the proviso to Section 129(1) of the Act, i.e., any insurance or banking company, or any company engaged in the generation or supply of electricity or to any other class of company for which a form of Balance Sheet and Statement of Profit and Loss has been specified in or under any other Act governing such class of company.
- It may, however, be clarified that for companies engaged in the generation and supply of electricity, neither the Electricity Act, 2003, nor the rules framed thereunder, prescribe any specific format for presentation of Financial Statements by an electricity company. Section 1(4) of the Act states that the Act will apply to electricity companies, to the extent it is not inconsistent with the provisions of the Electricity Act. Keeping this in view, Ind AS Schedule III as applicable may be followed by such companies till the time any other format is prescribed by the relevant statute.
- Listed entities shall follow guidelines issued by SEBI by way of circulars prescribing formats for publishing financial results (quarterly, half yearly and annual) which is guided by the relevant

provisions of Ind AS and Ind AS Schedule III and may make suitable modifications, as applicable.

Division II of the Schedule III provides instructions for preparation of financial statements and additional disclosure requirements for companies required to comply with Ind AS. The following is an overview of the Division II of the Schedule III:

1.5.1 Applicability

- It is applicable to every company to which Ind AS apply in preparation of its financial statements.
- The provisions of Schedule III also apply when a company is required to prepare consolidated financial statements, in addition to the disclosure requirements specified under Ind AS.
- Financial Statements include Balance Sheet, Statement of Changes in Equity for the period, Statement of Profit and Loss for the period and Notes. Cash Flow Statement shall be prepared in accordance with the requirements of the relevant Ind AS.
- The Ind AS Schedule III requires that if the compliance with the requirements of the Act including Ind AS as applicable to the companies, require any change in presentation or disclosure in the Financial Statements, the requirements of Ind AS Schedule III will stand modified accordingly.

1.5.2 Balance Sheet

- Schedule III provides a format of the balance sheet and sets out the minimum requirements of disclosure on the face of the balance sheet
- Items presented in the balance sheet are to be classified as current and non-current.
- Schedule III does not permit companies to avail of the option of presenting assets and liabilities in the order of liquidity, as provided by Ind AS 1, Presentation of Financial Statements.

1.5.3 Statement of Profit and Loss

- Schedule III provides a format of the statement of profit and loss and sets out the minimum requirements of disclosure on the face of the statement of profit and loss.
- The statement of profit and loss is to be presented in accordance with the nature of expenses and would include profit or loss for the period and other comprehensive income for the period.

1.5.4 Statement of changes in Equity

- This is a new component for preparers of financial statements that have historically prepared financial statements under Indian GAAP.

- The Statement of changes in equity would reconcile opening to closing amounts for each component of equity including reserves and surplus and items of other comprehensive income.
- The format also includes disclosure of the equity component of compound financial instruments in 'other equity', which is in accordance with Ind AS 32, *Financial Instruments: Presentation*.

1.5.5 Statement of Cash Flows

The Statement of cash flows would be presented when required in accordance with Ind AS 7, *Statement of Cash Flows*.

1.5.6 Notes

- Notes containing information in addition to that which is presented in the financial statements would be provided, including, where required, narrative descriptions or disaggregation of items recognised in the financial statements and information about items that do not qualify for such recognition.
- Disclosure under Ind AS (for e.g., fair value measurement reconciliation, fair value hierarchy, risk management and capital management, disclosure of interests in other entities, components of other comprehensive income, reconciliations on first-time adoption of Ind AS, etc.) shall be made in the Notes or by way of additional statement(s) unless required to be disclosed on the face of the Financial Statements.

1.5.7 Compliance with Ind AS and the Companies Act, 2013

In situations where compliance with the requirements of the 2013 Act including Ind AS requires any change in treatment or disclosure (including addition, amendment, substitution or deletion in the head/sub-head or any changes in the financial statements or statements forming part thereof) in the formats given in Schedule III, then Schedule III permits such changes to be made and the requirements of Schedule III would stand modified accordingly.

1.5.8 Conflict of requirements of Ind AS and Schedule III

It further mentions that disclosure requirements specified in Schedule III would be in addition to and not in substitution of the disclosure requirements specified in Ind AS. Companies would be required to make additional disclosures specified in Ind AS either in the notes or by way of additional statement(s) unless required to be disclosed on the face of financial statements. Similarly, all other disclosures as required by the 2013 Act should be made in the notes in addition to the requirements of Schedule III. This is an important provision, as it clarifies that in situations where an accounting treatment or disclosure in an Ind AS is in conflict with the requirements of Schedule III, companies are required to comply with the relevant Ind AS.

1.5.9 General Instruction

- Where any Act or Regulation requires specific disclosures to be made in the Financial Statements of a company, the said disclosures shall be made in addition to those required under Ind AS Schedule III.
- Note 8 to General Instructions for Preparation of Financial Statements in Ind AS Schedule III states that the terms used in the Ind AS Schedule III will carry the meaning as defined by the applicable Ind AS.

  For example, the terms such as 'associate', 'related parties', etc. will have the same meaning as defined in Ind AS notified under the Companies Ind AS Rules.

- For any terms which are not specifically defined in Ind AS, attention may also be drawn to the Framework for the preparation and presentation of Financial Statements in accordance with Indian Accounting Standards ('Ind AS Framework') issued by ICAI. However, if any term is not defined in the Ind AS Framework, the entity may give consideration to the principles described in Ind AS 8 for the purpose of developing and applying an accounting policy.
- A General Instruction on 'Materiality' has been included in Note 7 to General Instructions for Preparation of Financial Statements requiring Financial Statements to disclose items that could, individually or collectively, influence the economic decisions that users make on the basis of the Financial Statements. Materiality depends on the size or nature of the item or a combination of both, to be judged based on particular facts and in particular circumstances.
- Moreover, Ind AS 1 states w.r.t. 'materiality' that an entity shall present separately each material class of similar items. An entity shall present separately items of a dissimilar nature or function unless they are immaterial except when required by law.

1.6 GUIDANCE NOTE ON DIVISION II OF SCHEDULE III TO THE COMPANIES ACT, 2013

The Institute of Chartered Accountants of India has come out with the Guidance Note on Division II - Ind AS Schedule III to the Companies Act 2013. The Guidance Note provides guidance on each of the item of the Balance Sheet, Statement of Profit and Loss, Major differences in Division I and Division II of the Schedule III to the Companies Act, 2013 besides providing Illustrative format for Standalone financial statements and Consolidated Financial Statements etc.

1.7 LIST OF INDIAN ACCOUNTING STANDARDS

Ind AS	Title of Ind AS
101	First Time Adoption of Indian Accounting Standards
102	Share Based Payment
103	Business Combinations
104	Insurance Contracts
105	Non-current Assets Held for Sale and Discontinued Operations
106	Exploration for and Evaluation of Mineral Resources
107	Financial Instruments: Disclosures
108	Operating Segments
109	Financial Instruments
110	Consolidated Financial Statements
111	Joint Arrangements
112	Disclosure of Interests in Other Entities
113	Fair Value Measurement
114	Regulatory Deferral Accounts
115	Revenue from Contracts with Customers
116	Leases
1	Presentation of Financial Statements
2	Inventories
7	Statement of Cash Flows
8	Accounting Policies, Changes in Accounting Estimates and Errors
10	Events after the Reporting Period
12	Income Taxes
16	Property, Plant and Equipment
19	Employee Benefits

20	Accounting for Government Grants and Disclosure of Government Assistance
21	The Effects of Changes in Foreign Exchange Rates
23	Borrowing Costs
24	Related Party Disclosures
27	Separate Financial Statements
28	Investment in Associates and Joint Ventures
29	Financial Reporting in Hyperinflationary Economies
32	Financial Instruments: Presentation
33	Earnings per Share
34	Interim Financial Reporting
36	Impairment of Assets
37	Provisions, Contingent Liabilities and Contingent Assets
38	Intangible Assets
40	Investment Property
41	Agriculture

Note: In the study material, Ind AS have not been discussed sequentially; instead the related Ind AS have been grouped and discussed in the ensuing chapters for ease of understanding. For example, the 'Presentation based Ind AS' like Ind AS 1, Ind AS 34 and Ind AS 7 have been grouped in one chapter.

The ensuing paragraphs discuss Ind AS 1 "Presentation of Financial Statements'.

1.8 IND AS 1 'PRESENTATION OF FINANCIAL STATEMENTS'- INTRODUCTION

Ind AS 1 is a basic standard, which prescribes the overall requirements for the presentation of financial statements and guidelines for their structure, i.e., components of financial statements, viz., balance sheet, statement of profit and loss (including other comprehensive income), statement of cash flows and notes comprising significant accounting policies, etc. Further, the standard prescribes the minimum disclosures that are to be made in the financial statements and explains the general features of the financial statements. The presentation requirements prescribed in the standard are supplemented by the recognition, measurement and disclosure requirements set out in other Ind AS for specific transactions and other events.

1.9 OBJECTIVE

This standard prescribes the basis for presentation of general purpose financial statements to ensure comparability

a) with the entity's financial statements of previous periods and

b) with the financial statements of other entities.

It sets out overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content.

1.10 SCOPE

- This standard **applies** to all types of entities including those that present
  - (a) consolidated financial statements in accordance with Ind AS 110 'Consolidated Financial Statements'; and
  - (b) separate financial statements in accordance with Ind AS 27 'Separate Financial Statements'.
- This standard **does not apply** to structure and content of condensed interim financial statements prepared in accordance with Ind AS 34 except for para 15 to 35 of Ind AS 1.
- This Standard uses terminology that is suitable for profit-oriented entities, including public sector business entities.
- If entities with not for-profit activities in the private sector or the public sector apply this Standard, they may need to amend the descriptions used for particular line items in the financial statements and for the financial statements themselves.
- Similarly, entities that do not have equity as defined in IAS 32 Financial Instruments: Presentation (eg. some mutual funds) and entities whose share capital is not equity (eg. some co-operative entities) may need to adapt the financial statement presentation of members' or unitholders' interests.

1.11 DEFINITIONS

1. **General purpose financial statements** (referred to as 'financial statements') are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

2. **Impracticable** : Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so.

3. **Indian Accounting Standards (Ind AS)** are Standards prescribed under Section 133 of the Companies Act, 2013.

4. **Material**

   Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.

   Materiality depends on the nature or magnitude of information, or both. An entity assesses whether information, either individually or in combination with other information, is material in the context of its financial statements taken as a whole.

   Information is obscured if it is communicated in a way that would have a similar effect for primary users of financial statements to omitting or misstating that information.

   Examples of circumstances that may result in material information being obscured:

   (a) information regarding a material item, transaction or other event is disclosed in the financial statements but the language used is vague or unclear;

   (b) information regarding a material item, transaction or other event is scattered throughout the financial statements;

   (c) dissimilar items, transactions or other events are inappropriately aggregated;

   (d) similar items, transactions or other events are inappropriately disaggregated; and

   (e) the understandability of the financial statements is reduced as a result of material information being hidden by immaterial information to the extent that a primary user is unable to determine what information is material.

   Assessing whether information could reasonably be expected to influence decisions made by the primary users of a specific reporting entity's general purpose financial statements requires an entity to consider the characteristics of those users while also considering the entity's own circumstances.

   Many existing and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial statements for much of the financial information they need. Consequently, they are the primary users to whom general purpose financial statements are directed. Financial statements are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. At times, even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena.

5. **Notes** contain information in addition to that presented in the balance sheet, statement of profit and loss, other comprehensive income, statement of changes in equity and statement of cash flows.

   Notes provide narrative descriptions or disaggregation of items presented in those statements and information about items that do not qualify for recognition in those statements.

6. **Owners** are holders of instruments classified as equity.

7. **Profit or loss** is the total of income less expenses, excluding the components of other comprehensive income.

8. **Reclassification adjustments** are amounts reclassified to profit or loss in the current period that were recognised in other comprehensive income in the current or previous periods.

9. **Total comprehensive income** is the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners.

   Total comprehensive income comprises all components of 'profit or loss' and 'other comprehensive income'.

10. **Other comprehensive income** comprises items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other Ind AS.

The components of Other Comprehensive Income include the following:

S. No.	Components	Reference
1	Changes in revaluation surplus	Ind AS 16 'Property, Plant and Equipment' and Ind AS 38 'Intangible Assets'
2	Remeasurements of defined benefit plans	Ind AS 19, Employee Benefits
3	Gains and losses arising from translating the financial statements of a foreign operation	Ind AS 21 'The Effects of Changes in Foreign Exchange Rates'
4	Gains and losses from investments in equity instruments designated at fair value through other comprehensive income	Paragraph 5.7.5 of Ind AS 109, Financial Instruments
5	Gains and losses on financial assets measured at fair value through other comprehensive income	Paragraph 4.1.2A of Ind AS 109

6	The effective portion of gains and losses on hedging instruments in a cash flow hedge and the gains and losses on hedging instruments that hedge investments in equity instruments measured at fair value through other comprehensive income	Paragraph 5.7.5 of Ind AS 109 (see Chapter 6 of Ind AS 109)
7	For particular liabilities designated as at fair value through profit or loss, the amount of the change in fair value that is attributable to changes in the liability's credit risk	Paragraph 5.7.7 of Ind AS 109
8	Changes in the value of the time value of options when separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the changes in the intrinsic value	Ind AS 109
9	Changes in the value of the forward elements of forward contracts when separating the forward element and spot element of a forward contract and designating as the hedging instrument only the changes in the spot element, and changes in the value of the foreign currency basis spread of a financial instrument when excluding it from the designation of that financial instrument as the hedging instrument	Ind AS 109

1.12 PURPOSE OF FINANCIAL STATEMENTS

The objective of general purpose financial statements is to provide information about the financial position, financial performance, and cash flows of an entity that is useful to a wide range of users in making economic decisions. To meet the objective, financial statements provide information about an entity's:

- assets;
- liabilities;
- equity;
- income and expenses, including gains and losses;

- contributions by and distributions to owners in their capacity as owners; and
- cash flows.

Information, along with other information in the notes, assists users of financial statements in predicting the entity's future cash flows and, in particular, their timing and certainty.

1.13 COMPLETE SET OF FINANCIAL STATEMENTS

A complete set of financial statements comprises:

- a balance sheet as at the end of the period;
- a statement of profit and loss for the period;
- statement of changes in equity for the period;
- a statement of cash flows for the period;
- notes, comprising significant accounting policies and other explanatory information;
- comparative information in respect of the preceding period;
- a balance sheet as at the beginning of the preceding period when an entity applies an accounting policy retrospectively or makes a retrospective restatements of items in its financial statements, or when it reclassifies items in its financial statements.

An entity shall present a single statement of profit and loss, with profit or loss and other comprehensive income presented in two sections. The sections shall be presented together, with the profit or loss section presented first followed directly by the other comprehensive income section.

Many entities present reports and statements such as financial reviews by management, environmental reports, and value added statements that are outside the financial statements. Such reports and statements that are outside the financial statements are outside the scope of Ind AS.

1.14 GENERAL FEATURES OF FINANCIAL STATEMENTS

1.14.1 Presentation of True and Fair View and compliance with Ind AS

Financial statements shall present a true and fair view of the financial position, financial performance and cash flows of an entity. Presentation of true and fair view requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework. The application of Ind AS, with additional disclosure when necessary, is presumed to result in financial statements that present a true and fair view.

1.14.1.1 An explicit and unreserved statement

An entity whose financial statements comply with Ind AS shall make an explicit and unreserved statement of such compliance in the notes.

An entity shall not describe financial statements as complying with Ind AS unless they comply with all the requirements of Ind AS. In virtually all circumstances, presentation of a true and fair view is achieved by compliance with applicable Ind AS. Presentation of a true and fair view also requires an entity:

(a) to select and apply accounting policies in accordance with Ind AS 8 Accounting Policies, Changes in Accounting Estimates and Errors. Ind AS 8 sets out a hierarchy of authoritative guidance that management considers in the absence of an Ind AS that specifically applies to an item.

(b) to present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information.

(c) to provide additional disclosures when compliance with the specific requirements in Ind AS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

1.14.1.2 Inappropriate Accounting Policies

An entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material.

1.14.1.3 Departure from the Requirements of an Ind AS — Whether Permissible?

In the extremely rare circumstances in which management concludes that compliance with a requirement in an Ind AS would be so misleading that it would conflict with the objective of financial statements set out in the Framework, the entity shall depart from that requirement if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure.

When an entity departs from a requirement of an Ind AS, it shall disclose:

(a) that management has concluded that the financial statements present a true and fair view of the entity's financial position, financial performance and cash flows;

(b) that it has complied with applicable Ind AS, except that it has departed from a particular requirement to present a true and fair view;

(c) the title of the Ind AS from which the entity has departed, the nature of the departure, including the treatment that the Ind AS would require, the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the Framework, and the treatment adopted; and

(d) for each period presented, the financial effect of the departure on each item in the financial statements that would have been reported in complying with the requirement.

When an entity has departed from a requirement of an Ind AS in a prior period, and that departure affects the amounts recognised in the financial statements for the current period, it shall make the disclosures given above. Paragraph 21 applies, for example, when an entity departed in a prior period from a requirement in an Ind AS for the measurement of assets or liabilities and that departure affects the measurement of changes in assets and liabilities recognised in the current period's financial statements.

In the extremely rare circumstances in which management concludes that compliance with a requirement in an Ind AS would be so misleading that it would conflict with the objective of financial statements set out in the Framework, but the relevant regulatory framework prohibits departure from the requirement, the entity shall, to the maximum extent possible, reduce the perceived misleading aspects of compliance by disclosing:

(a) the title of the Ind AS in question, the nature of the requirement, and the reason why management has concluded that complying with that requirement is so misleading in the circumstances that it conflicts with the objective of financial statements set out in the Framework; and

(b) for each period presented, the adjustments to each item in the financial statements that management has concluded would be necessary to present a true and fair view.

Illustration 1

An entity prepares its financial statements that contain an explicit and unreserved statement of compliance with Ind AS. However, the auditor's report on those financial statements contains a qualification because of disagreement on application of one Accounting Standard. In such case, is it acceptable for the entity to make an explicit and unreserved statement of compliance with Ind AS?

Solution

Yes, it is possible for an entity to make an unreserved and explicit statement of compliance with Ind AS, even though the auditor's report contains a qualification because of disagreement on application of Accounting Standard(s), as the preparation of financial statements is the responsibility of the entity's management and not the auditors. In case the management has a bonafide reason to believe that it has complied with all Ind AS, it can make an explicit and unreserved statement of compliance with Ind AS.

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1.14.2 Going concern

Financial statements prepared under Ind AS should be prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. Management is required to assess, at the time of preparing the financial statements, the entity's ability to continue as a going concern, and this assessment should cover the entity's prospects for at least 12 months from the end of the reporting period. The 12-month period for considering the entity's future is a minimum requirement; an entity cannot, for example, prepare its financial statements on a going concern basis if it intends to cease operations 18 months from the end of the reporting period.

The assessment of the entity's status as a going concern will often be straightforward. A profitable entity with no financing problems will almost certainly be a going concern. In other cases, management might need to consider very carefully the entity's ability to meet its liabilities as they fall due. Detailed cash flow and profit forecasts might be required to satisfy management that the entity is a going concern.

If management has significant doubt of the entity's ability to continue as a going concern, the uncertainties should be disclosed.

In case the financial statements are not prepared on a going concern basis, the entity should disclose the basis of preparation of financial statements and also the reason why the entity is not regarded as a going concern.

Events that occur after the reporting period might indicate that the entity is no longer a going concern. An entity does not prepare its financial statements on a going concern basis if management's post-year end assessment indicates that it is not a going concern. Any financial statements that are prepared after that assessment (including the financial statements in respect of which management are making the assessment) are not prepared on a going concern basis. This is consistent with IAS 10, which requires a fundamental change to the basis of accounting when the going concern assumption is no longer appropriate.

Illustration 2

Entity XYZ is a large manufacturer of plastic products for the local market. On 1st April, 20X6 the newly elected government unexpectedly abolished all import tariffs, including the 40 per cent tariff on all imported plastic products. Many other economic reforms implemented by the new government contributed to the value of the country's currency INR appreciating significantly against most other currencies. The currency appreciation severely reduced the competitiveness of the entity's products.

Before 20X6 entity XYZ was profitable. However, because it was unable to compete with low priced imports, entity XYZ went into losses. As at 31st March, 20X7, entity XYZ's equity was INR 1,000. During the second quarter of financial year ended 31 March 20X7, the management restructured entity's operations. That restructuring helped reduce losses for the third and fourth quarters to INR 400 and INR 380, respectively. During the year ended 31st March, 20X7, entity XYZ reported a loss of INR 4,000. In January 20X7, the local plastic industry and labour union lobbied government to reinstate tariffs on plastic. On 15th March, 20X7, the government announced that it would reintroduce limited plastic import tariffs at 10 percent in 20X8. However, it emphasised that those tariffs would not be as protective as the tariffs enacted by the previous government. In its latest economic forecast, the government predicts a stable currency exchange rate in the short term with a gradual weakening of the jurisdiction's currency in the longer term.

Management of the entity XYZ undertook a going concern assessment at 31st March, 20X7. Management projects/forecasts that imposition of a 10 per cent tariff on the import of plastic products would, at current exchange rates, result in entity XYZ returning to profitability. How should the management of entity XYZ disclose the information about the going concern assessment in entity XYZ's 31st March, 20X7 annual financial statements?

Solution

Going concern is a general feature to be considered while presenting the financial statements. As per Ind AS 1, when preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties. An entity is required to disclose the facts, if the financial statements are not prepared on a going concern basis. Along with the reason, as to why the financial statements are not prepared on a going concern basis.

While assessing the going concern assumption, an entity is required to take into consideration all factors covering atleast but not limited to 12 months from the end of reporting period.

On the basis of Ind AS 1 and the facts and circumstances of this case, the following disclosure is appropriate:

Extracts from the notes to entity XYZ's 31st March, 20X7 financial statements

Note 1: Basis of preparation

On the basis of management's assessment at 31 March 20X7, the financial statements have been prepared on the going concern basis. However, management's assessment assumes that the government will reintroduce limited plastic import tariffs and that the currency exchange rate will remain constant. On 15 March 20X7, the government announced that limited import tariffs will be imposed in 20X8. However, the government emphasised that the tariff would not be as protective as the 40 percent tariff in effect before 20X7.

Provided that INR does not strengthen, management projects/forecasts that a 10 percent tariff on all plastic products would result in entity XYZ returning to profitability. As at 31st March, 20X7 entity XYZ had net assets of INR 1,000. If import tariffs are not imposed and currency exchange rates remain unchanged, entity XYZ's liabilities could exceed its assets by the end of financial year 20X7-X8. On the basis of their assessment of these factors, management believes that entity XYZ is a going concern.

*****

1.14.3 Accrual basis of accounting

- An entity shall prepare its financial statements, except for cash flow information, using the accrual basis of accounting.
- When the accrual basis of accounting is used, an entity recognises items as assets, liabilities, equity, income and expenses (the elements of financial statements) when they satisfy the definitions and recognition criteria for those elements in the Framework.

1.14.4 Materiality and aggregation

- An entity shall present separately each material class of similar items. An entity shall present separately items of a dissimilar nature or function unless they are immaterial except when required by law.
- Financial statements result from processing large numbers of transactions or other events that are aggregated into classes according to their nature or function. The final stage in the process of aggregation and classification is the presentation of condensed and classified data, which form line items in the financial statements. If a line item is not individually material, it is aggregated with other items either in those statements or in the notes. An item that is not sufficiently material to warrant separate presentation in those statements may warrant separate presentation in the notes.
- An entity need not provide a specific disclosure required by an Ind AS if the information is not material except when required by law.

Example

1. Entity A has done a wrong classification of assets between 2 categories of plant and machinery. Such a classification would not be material in amount if it affected two categories of plant or equipment, however, it might be material if it changed the classification between a non-current and a current asset category.
2. Losses from bad debts or pilferage that could be shrugged off as routine by a large business may threaten the continued existence of a small business.
3. An error in inventory valuation may be material in a small enterprise for which it may cut earnings by half but could be immaterial in an enterprise for which it might make a barely perceptible ripple in the earnings.

1.14.5 Offsetting

- An entity shall not offset assets and liabilities or income and expenses, unless required or permitted by an Ind AS.
- An entity reports separately both assets and liabilities, and income and expenses. Measuring assets net of valuation allowances — for example, obsolescence allowances on inventories and doubtful debts allowances on receivables — is not offsetting.
- Ind AS 115, 'Revenue from Contracts with Customers', requires an entity to measure revenue from contracts with customers at the amount of consideration to which the entity expects to be entitled in exchange for transferring promised goods or services. For example, the amount of revenue recognized reflects any trade discounts and volume rebates the entity allows. An entity undertakes, in the course of its ordinary activities, other transactions that do not generate revenue but are incidental to the main revenue-generating activities. An entity presents the

results of such transactions, when this presentation reflects the substance of the transaction or other event, by netting any income with related expenses arising on the same transaction.

Example:

(a) an entity presents gains and losses on the disposal of non-current assets, including investments and operating assets, by deducting from the amount of consideration on disposal the carrying amount of the asset and related selling expenses; and

(b) an entity may net expenditure related to a provision that is recognised in accordance with Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets, and reimbursed under a contractual arrangement with a third party (for example, a supplier's warranty agreement) against the related reimbursement.'';

- In addition, an entity presents on a net basis gains and losses arising from a group of similar transactions, for example, foreign exchange gains and losses or gains and losses arising on financial instruments held for trading. However, an entity presents such gains and losses separately if they are material.

Illustration 3

Is offsetting of revenue against expenses, permissible in case of a company acting as an agent and having sub-agents, where commission is paid to sub-agents from the commission received as an agent?

Solution

On the basis of the guidance regarding offsetting, net presentation in the given case would not be appropriate, as it would not reflect substance of the transaction and would detract from the ability of users to understand the transaction.

Accordingly, the commission received by the company as an agent is the gross revenue of the company. The amount of commission paid by it to the sub-agent should be considered as an expense and should not be offset against commission earned by it.

*****

1.14.6 Frequency of reporting

- An entity shall present a complete set of financial statements (including comparative information) at least annually.
- When an entity changes the end of its reporting period and presents financial statements for a period longer or shorter than one year, an entity shall disclose, in addition to the period covered by the financial statements:
  - the reason for using a longer or shorter period, and
  - the fact that amounts presented in the financial statements are not entirely comparable.

Example

In 20X8 entity 'Superb' was acquired by entity 'Happy go lucky'. To align its reporting date with that of its parent, Superb changed the end of its annual reporting period from 31st January to 31st March. Consequently, entity Superb's reporting period for the year ended 31st March, 20X8 is 14 months. On the basis of these facts, the following disclosure would be appropriate:

Extract from the notes to entity Superb's 31st March, 20X8 financial statements:

Note 1

Basis of preparation and accounting policies

Reporting period

To align the entity's reporting period with that of its parent (Happy Go Luck), the entity changed the end of its reporting period from 31st January to 31st March. Amounts presented for the period ended 31st March, 20X8 are for 14 months. Comparative figures are for a 12 months period. Consequently, comparative amounts for the statement of comprehensive income, statement of changes in equity, statement of cash flows and related notes are not entirely comparable.

1.14.7 Comparative information

1.14.7.1 Minimum comparative information

- An entity should present comparative information in respect of the preceding period for all amounts reported in the current period's financial statements except when Ind AS permit or require otherwise.
- Comparative information for narrative and descriptive information should be included if it is relevant to understand the current period's financial statements.

  For example, in the current period an entity discloses details of a legal dispute whose outcome was uncertain at the end of the immediately preceding reporting period and that is yet to be resolved.

- An entity shall present, as a minimum:
  - 2 Balance Sheets
  - 2 Statement of Profit and Loss
  - 2 Statement of Cash Flows
  - 2 Statement of Changes in Equity and
  - Related Notes.

1.14.7.2 Additional comparative information

An entity may present comparative information in addition to the minimum comparative financial statements required by Ind ASs, as long as that information is prepared in accordance with Ind AS. This comparative information may consist of one or more statements referred to in 'Complete set of financial statements' but need not comprise a complete set of financial statements. When this is the case, the entity shall present related note information for those additional statements.

Example

An entity may present a third statement of profit or loss (thereby presenting the current period, the preceding period and one additional comparative period). However, the entity is not required to present a third balance sheet, a third statement of cash flows or a third statement of changes in equity (ie an additional financial statement comparative). The entity is required to present, in the notes to the financial statements, the comparative information related to that additional statement of profit or loss and other comprehensive income.

Illustration 4

A retail chain acquired a competitor in March, 20X1 and accounted for the business combination under Ind AS 103 on a provisional basis in its 31st March, 20X1 annual financial statements. The business combination accounting was finalised in 20X1-20X2 and the provisional fair values were updated. As a result, the 20X0-20X1 comparatives were adjusted in the 20X1-X2 annual financial statements. Does the restatement require an opening statement of financial position (that is, an additional statement of financial position) as of 1st April, 20X0?

Solution

An additional statement of financial position is not required, because the acquisition had no impact on the entity's financial position at 1st April, 20X0.

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1.14.7.3 Change in accounting policy, retrospective restatement or reclassification

- When an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements or reclassifies items in its financial statements, it shall present, as a minimum, three balance sheets, two of each of the other statements, and related notes. An entity presents balance sheets as at
  - the end of the current period,
  - the end of the preceding period, and
  - the beginning of the preceding period.
- When an entity is required to present an additional balance sheet the beginning of the preceding period, it must disclose the information as given below and in Ind AS 8. However, it

need not present the related notes to the opening balance sheet as at the beginning of the preceding period.

- When the entity changes the presentation or classification of items in its financial statements, the entity shall reclassify comparative amounts unless reclassification is impracticable.
- When the entity reclassifies comparative amounts, the entity shall disclose:
  - the nature of the reclassification;
  - the amount of each item or class of items that is reclassified; and
  - the reason for the reclassification.
- When it is impracticable to reclassify comparative amounts, an entity shall disclose:
  - the reason for not reclassifying the amounts, and
  - the nature of the adjustments that would have been made if the amounts had been reclassified.

1.14.8 Consistency of presentation

An entity shall retain the presentation and classification of items in the financial statements from one period to the next unless:

- it is apparent, following a significant change in the nature of the entity's operations or a review of its financial statements, that another presentation or classification would be more appropriate having regard to the criteria for the selection and application of accounting policies in Ind AS 8; or
- an Ind AS requires a change in presentation.

Example

A significant acquisition or disposal, or a review of the presentation of the financial statements, might suggest that the financial statements need to be presented differently. An entity changes the presentation of its financial statements only if the changed presentation provides information that is reliable and more relevant to users of the financial statements and the revised structure is likely to continue, so that comparability is not impaired. When making such changes in presentation, an entity reclassifies its comparative information.

1.15 STRUCTURE AND CONTENT

Ind AS 1 requires particular disclosures in the balance sheet or in the statement of profit and loss, or in the statement of changes in equity and requires disclosure of other line items either in those statements or in the notes.

1.15.1 Identification of Financial Statements

- An entity shall clearly identify the financial statements and distinguish them from other information in the same published document. Ind AS apply only to financial statements, and not necessarily to other information presented in an annual report, a regulatory filing, or another document though they may be useful to users.
- An entity shall display the following information prominently:
    - the name of the reporting entity or other means of identification, and any change in that information from the end of the preceding reporting period
    - whether the financial statements are of an individual entity or a group of entities;
    - reporting date or the reporting period
    - the presentation currency
    - the level of rounding used in presenting amounts in the financial statements.
    - An entity meets above requirements by presenting appropriate headings for pages, statements, notes, columns and the like. Judgement is required in determining the best way of presenting such information.

      For example, when an entity presents the financial statements electronically separate pages are not always used; an entity then presents the above items to ensure that the information included in the financial statements can be understood.
    - An entity often makes financial statements more understandable by presenting information in thousands or millions of units of the presentation currency. This is acceptable as long as the entity discloses the level of rounding and does not omit material information.

> As per Schedule III of Companies Act 2013, Depending upon the turnover of the company, the figures appearing in the financial statements may be rounded off as below:
>
> - Less than one hundred crore rupees - To the nearest hundreds, thousands, lakhs or millions, or decimals thereof.
> - One hundred crore rupees or more- To the nearest, lakhs, millions or crores, or decimals thereof.
>
> Once a unit of measurement is used, it should be used uniformly in the Financial Statements.

1.15.2 Balance Sheet

At a minimum, the balance sheet shall include following items:

a	Property, plant and equipment
b	Investment property
c	Intangible assets
d	Financial assets (excluding amounts shown under (e, h & i)
e	Investments accounted for using the equity method
f	Biological assets
g	Inventories
h	Trade and other receivables
i	Cash and cash equivalents
j	The total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with Ind AS 105 Non-current Assets Held for Sale and Discontinued Operations
k	Trade and other payables
l	Provisions
m	Financial liabilities (excluding amounts shown under k and l)
n	Liabilities and assets for current tax, as defined in Ind AS 12 Income Taxes
o	Deferred tax liabilities and deferred tax assets, as defined in Ind AS 12
p	Liabilities included in disposal groups classified as held for sale in accordance with Ind AS 105
q	Non-controlling interests, presented within equity
r	Issued capital and reserves attributable to owners of the parent

Additional line items, headings and subtotals in the balance sheet should be presented when such presentation is relevant to an understanding of the entity's financial position.

The descriptions of the line items, and the order in which they are shown, can be adapted according to the entity's nature and its transactions.

Example

Financial institutions would amend the descriptions of line items to provide information that is relevant to the operations of financial institutions.

1.15.2.1 Distinction between Current / Non-current

Most entities preparing Ind AS financial statements are required to present the face of the balance sheet, differentiating between current and non-current assets and between current and non-current liabilities.

An entity shall present current and non-current assets, and current and non-current liabilities, as separate classifications in its balance sheet except when a presentation based on liquidity provides information that is reliable and more relevant. When that exception applies, an entity shall present all assets and liabilities in order of liquidity.

Whichever method of presentation is adopted, an entity shall disclose the amount expected to be recovered or settled after more than twelve months for each asset and liability line item that combines amounts expected to be recovered or settled:

a) no more than twelve months after the reporting period, and

b) more than twelve months after the reporting period.

When an entity supplies goods or services within a clearly identifiable operating cycle, separate classification of current and non-current assets and liabilities in the balance sheet provides useful information by distinguishing the net assets that are continuously circulating as working capital from those used in the entity's long-term operations. It also highlights assets that are expected to be realised within the current operating cycle, and liabilities that are due for settlement within the same period.

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

Note:

1. Financial institutions may present assets and liabilities in increasing or decreasing order of liquidity if the presentation is reliable and more relevant than a current/ non-current presentation. This is because such entity does not supply goods or services within a clearly identifiable operating cycle.

2. An entity is permitted to present some of its assets and liabilities using a current/non-current classification and others in order of liquidity. The need for a mixed basis of presentation might arise when an entity has diverse operations.

1.15.2.2 Current Assets

An entity shall classify an asset as current when:

(a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;

(b) it holds the asset primarily for the purpose of trading;

(c) it expects to realise the asset within twelve months after the reporting period; or

(d) the asset is cash or a cash equivalent (as defined in Ind AS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

An entity shall classify all other assets as non-current.

This Standard uses the term 'non-current' to include tangible, intangible and financial assets of a long-term nature. It does not prohibit the use of alternative descriptions as long as the meaning is clear.

1.15.2.3 Operating Cycle

The operating cycle of an entity is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. When the entity's normal operating cycle is not clearly identifiable, it is assumed to be twelve months. Current assets include assets (such as inventories and trade receivables) that are sold, consumed or realised as part of the normal operating cycle even when they are not expected to be realised within twelve months after the reporting period. Current assets also include assets held primarily for the purpose of trading

Examples

- Some financial assets classified as held for trading in accordance with Ind AS 109
- Current portion of non-current financial assets.

Example:

A) An entity produces whisky from barley, water and yeast in a 24-month distillation process. At the end of the reporting period the entity has one month's supply of barley and yeast raw materials, 800 barrels of partly distilled whisky and 200 barrels of distilled whisky.

All raw materials (barley and yeast) work in process (partly distilled whisky) and finished goods (distilled whisky) are inventories. The raw materials are expected to be realised (ie turned into cash after being processed into whisky) in the entity's normal operating cycle. Therefore, even though the realisation is expected to take place more than twelve months after the end of the reporting period, the raw materials, work in progress and finished goods are current assets.

B) An entity owns a machine with which it manufactures goods for sale. It also owns the building in which it carries out its commercial activities.

The machine and the building are non-current assets because:

- they are not cash or cash equivalents;
- they are not expected to be realised or consumed in the entity's normal operating cycle;
- they are not held for the purpose of trading; and
- they are not expected to be realised within twelve months of the end of the reporting period.

C) ***On 31 December 20x2, an entity replaced a machine in its production line. The replaced machine was sold to a competitor for ₹ 300,000. Payment is due 15 months after the end of the reporting period.***

The receivable is a non-current asset because:

- it is not cash or a cash equivalent;
- it is not expected to be realised or consumed in the entity's normal operating cycle;
- it is not held for the purpose of trading; and
- it is not expected to be realised within twelve months of the end of the reporting period.

Note: If payment was due in less than twelve months from the end of the reporting period, it would have been classified as a current asset.

D) ***On 1st April, 20X2, XYZ Ltd invested ₹ 1,500,000 surplus funds in corporate bonds that bear interest at 8 per cent per year. Interest is payable on the corporate bonds on 1st April, of each year. The principal is repayable in three annual instalments of ₹ 500,000 starting from 1st April, 20X3.***

In its statement of financial position at 31st March, 20X3, the entity must present the ₹ 1,20,000 accrued interest and ₹ 500,000 current portion of the non-current loan (i.e. the portion repayable on 31st March, 20X3) as current assets because they are expected to be realised within twelve months of the end of the reporting period.

The instalments of ₹ 10,00,000 due later than twelve months after the end of the reporting period is presented as a non-current asset because it is not cash or a cash equivalent as it is not expected to be realised or consumed in the entity's normal operating cycle, it is not held for the purpose of trading and it is not expected to be realised within twelve months of the end of the reporting period.

Illustration 5

X Ltd provides you the following information:

Raw material stock holding period : 3 months

Work-in-progress holding period : 1 month

Finished goods holding period : 5 months

Debtors collection period : 5 months

You are requested to compute the operating cycle of X Ltd.

Solution

The operating cycle of X Ltd. will be computed as under:

Raw material stock holding period + Work-in-progress holding period + Finished goods holding period + Debtors collection period = 3 + 1 + 5 + 5 = 14 months.

*****

Illustration 6

Inventory or trade receivables of X Ltd. are normally realised in 15 months. How should X Ltd. classify such inventory/trade receivables: current or non-current if these are expected to be realised within 15 months?

Solution

These should be classified as current.

*****

Illustration 7

B Ltd. produces aircrafts. The length of time between first purchasing raw materials to make the aircrafts and the date the company completes the production and delivery is 9 months. The company receives payment for the aircrafts 7 months after the delivery.

(a) What is the length of operating cycle?

(b) How should it treat its inventory and debtors?

Solution

(a) The length of the operating cycle will be 16 months.

(b) Assuming the inventory and debtors will be realised within normal operating cycle, i.e., 16 months, both the inventory as well as debtors should be classified as current.

*****

1.15.2.4 Current Liabilities

- An entity shall classify a liability as current when:

  (a) it expects to settle the liability in its normal operating cycle;

  (b) it holds the liability primarily for the purpose of trading;

  (c) the liability is due to be settled within twelve months after the reporting period; or

  (d) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its *classification.*

- An entity shall classify all other liabilities as non-current.

- Some current liabilities, such as trade payables and some accruals for employee and other operating costs, are part of the working capital used in the entity's normal operating cycle.
- An entity classifies such operating items as current liabilities even if they are due to be settled more than twelve months after the reporting period.
- The same normal operating cycle applies to the classification of an entity's assets and liabilities.
- When the entity's normal operating cycle is not clearly identifiable, it is assumed to be twelve months.
- Other current liabilities are not settled as part of the normal operating cycle, but are due for settlement within twelve months after the reporting period or held primarily for the purpose of trading.

  Examples are some financial liabilities classified as held for trading in accordance with Ind AS 109, bank overdrafts, and the current portion of non-current financial liabilities, dividends payable, income taxes and other non-trade payables.

- Financial liabilities that provide financing on a long-term basis (i.e. are not part of the working capital used in the entity's normal operating cycle) and are not due for settlement within twelve months after the reporting period are non-current liabilities.
- An entity classifies its financial liabilities as current when they are due to be settled within twelve months after the reporting period, even if:
  - the original term was for a period longer than twelve months, and
  - an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the reporting period and before the financial statements are approved for issue.
- If an entity expects, and has the discretion, to refinance or roll over an obligation for at least twelve months after the reporting period under an existing loan facility, it classifies the obligation as non-current, even if it would otherwise be due within a shorter period. However, when refinancing or rolling over the obligation is not at the discretion of the entity (for example, there is no arrangement for refinancing), the entity does not consider the potential to refinance the obligation and classifies the obligation as current.
- When an entity breaches a provision 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, the entity does not classify the liability as current, even if the lender agreed, after the reporting period and before the approval of the financial statements for issue, not to demand payment as a consequence of the breach.
- However, an entity classifies 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 twelve months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment.

Illustration 8

On 1st April, 20X3, Charming Ltd issued 100,000 ₹ 10 bonds for ₹ 1,000,000. On 1st April, each year interest at the fixed rate of 8 per cent per year is payable on outstanding capital amount of the bonds (ie the first payment will be made on 1st April, 20X4). On 1st April each year (i.e from 1st April, 20X4), Charming Ltd has a contractual obligation to redeem 10,000 of the bonds at ₹ 10 per bond. In its statement of financial position at 31st March, 20X4. How should this be presented in the financial statements?

Solution

Charming Ltd must present ₹ 80,000 accrued interest and ₹ 1,00,000 current portion of the non-current bond (i.e. the portion repayable on 1st April, 20X4) as current liabilities. The ₹ 9,00,000 due later than 12 months after the end of the reporting period is presented as a non-current liability.

*****

Illustration 9

X Ltd provides you the following information:

Raw material stock holding period : 3 months

Work-in-progress holding period : 1 month

Finished goods holding period : 5 months

Debtors collection period : 5 months

The trade payables of the Company are paid in 12.5 months. Should these be classified as current or non-current?

Solution

In this case, the operating cycle of X Ltd. is 14 months. Since the trade payables are expected to be settled within the operating cycle i.e. 12.5 months, they should be classified as a current.

*****

Illustration 10

Entity A has two different businesses, real estate and manufacturing of passenger vehicles. With respect to the real estate business, the entity constructs residential apartments for customers and the normal operating cycle is three to four years. With respect to the business of manufacture of passenger vehicles, normal operating cycle is 15 months. Under such circumstance where an entity has different operating cycles for different types of businesses, how classification into current and non-current be made?

Solution

As per paragraph 66(a) of Ind AS 1, an asset should be classified as current if an entity expects to realise the same, or intends to sell or consume it in its normal operating cycle. Similarly, as per paragraph 69(a) of Ind AS 1, a liability should be classified as current if an entity expects to settle the liability in its normal operating cycle. In this situation, where businesses have different operating cycles, classification of asset/liability as current/non- current would be in relation to the normal operating cycle that is relevant to that particular asset/liability. It is advisable to disclose the normal operating cycles relevant to different types of businesses for better understanding.

*****

Illustration 11

An entity has placed certain deposits with various parties. How the following deposits should be classified, i.e., current or non-current?

(a) Electricity Deposit

(b) Tender Deposit/Earnest Money Deposit [EMD]

(c) GST Deposit paid under dispute or GST payment under dispute.

Solution

(a) **Electricity Deposit** - At all points of time, the deposit is recoverable on demand, when the connection is not required. However, practically, such electric connection is required as long as the entity exists. Hence, from a commercial reality perspective, an entity does not expect to realise the asset within twelve months from the end of the reporting period. Hence, electricity deposit should be classified as a non-current asset.

(b) **Tender Deposit/Earnest Money Deposit [EMD] -** Generally, tender deposit/EMD are paid for participation in various bids. They normally become recoverable if the entity does not win the bid. Bid dates are known at the time of tendering the deposit. But until the date of the actual bid, one is not in a position to know if the entity is winning the bid or otherwise. Accordingly, depending on the terms of the deposit if entity expects to realise the deposit within a period of twelve months, it should be classified as current otherwise non-current.

(c) **GST Deposit paid under dispute or GST payment under dispute -** Classification of GST deposits paid to the Government authorities in the event of any legal dispute, which is under protest would depend on the facts of the case and the expectation of the entity to realise the same within a period of twelve months. In the case the entity expects these to be realised within 12 months, it should classify such amounts paid as current else these should be classified as non-current.

*****

Illustration 12

Paragraph 69(a) of Ind AS 1 states "An entity shall classify a liability as current when it expects to settle the liability in its normal operating cycle". An entity develops tools for customers and this normally takes a period of around 2 years for completion. The material is supplied by the customer and hence the entity only renders a service. For this, the entity receives payment upfront and credits the amount so received to "Income Received in Advance". How should this "Income Received in Advance" be classified, i.e., current or non- current?

Solution

Ind AS 1 provides "Some current liabilities, such as trade payables and some accruals for employee and other operating costs, are part of the working capital used in the entity's normal operating cycle. An entity classifies such operating items as current liabilities even if they are due to be settled more than twelve months after the reporting period."

In accordance with the above, income received in advance would be classified as current liability since it is a part of the working capital, which the entity expects to earn within its normal operating cycle.

*****

Illustration 13

An entity has taken a loan facility from a bank that is to be repaid within a period of 9 months from the end of the reporting period. Prior to the end of the reporting period, the entity and the bank enter into an arrangement, whereby the existing outstanding loan will, unconditionally, roll into the new facility which expires after a period of 5 years.

(a) How should such loan be classified in the balance sheet of the entity?

(b) Will the answer be different if the new facility is agreed upon after the end of the reporting period?

(c) Will the answer to (a) be different if the existing facility is from one bank and the new facility is from another bank?

(d) Will the answer to (a) be different if the new facility is not yet tied up with the existing bank, but the entity has the potential to refinance the obligation?

Solution

(a) The loan is not due for payment at the end of the reporting period. The entity and the bank have agreed for the said roll over prior to the end of the reporting period for a period of 5 years. Since the entity has an unconditional right to defer the settlement of the liability for at least twelve months after the reporting period, the loan should be classified as non-current.

(b) Yes, the answer will be different if the arrangement for roll over is agreed upon after the end of the reporting period, since assessment is required to be made based on terms of the existing loan facility. As at the end of the reporting period, the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Hence the loan is to be classified as current.

(c) Yes, loan facility arranged with new bank cannot be treated as refinancing, as the loan with the earlier bank would have to be settled which may coincide with loan facility arranged with a new bank. In this case, loan has to be repaid within a period of 9 months from the end of the reporting period, therefore, it will be classified as current liability.

(d) Yes, the answer will be different and the loan should be classified as current. This is because, as per paragraph 73 of Ind AS 1, when refinancing or rolling over the obligation is not at the discretion of the entity (for example, there is no arrangement for refinancing), the entity does not consider the potential to refinance the obligation and classifies the obligation as current.

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Illustration 14

In December 2XX1 an entity entered into a loan agreement with a bank. The loan is repayable in three equal annual instalments starting from December 2XX5. One of the loan covenants is that an amount equivalent to the loan amount should be contributed by promoters by March 24 2XX2, failing which the loan becomes payable on demand. As on March 24, 2XX2, the entity has not been able to get the promoter's contribution. On March 25, 2XX2, the entity approached the bank and obtained a grace period up to June 30, 2XX2 to get the promoter's contribution.

The bank cannot demand immediate repayment during the grace period. The annual reporting period of the entity ends on March 31, 2XX2.

(a) As on March 31, 2XX2, how should the entity classify the loan?

(b) Assume that in anticipation that it may not be able to get the promoter's contribution by due date, in February 2XX2, the entity approached the bank and got the compliance date extended up to June 30, 2XX2 for getting promoter's contribution. In this case will the loan classification as on March 31, 2XX2 be different from (a) above?

Solution

(a) Paragraph 75 of Ind AS 1, inter alia, provides, "An entity classifies 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 twelve months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment." In the present case, following the default, grace period within which an entity can rectify the breach is less than twelve months after the reporting period. Hence as on March 31, 2XX2, the loan will be classified as current.

(b) Ind AS 1 deals with classification of liability as current or non-current in case of breach of a loan covenant and does not deal with the classification in case of expectation of breach. In this case, whether actual breach has taken place or not is to be assessed on June 30, 2XX2, i.e., after the reporting date. Consequently, in the absence of actual breach of the loan covenant as on March 31, 2XX2, the loan will retain its classification as non-current.

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Illustration 15

OMN Ltd has a subsidiary MN Ltd. OMN Ltd provides a loan to MN Ltd at 8% interest to be paid annually. The loan is required to be paid whenever demanded back by OMN Ltd.

How should the loan be classified in the financial statements of OMN Ltd? Will it be any different for MN Ltd?

Solution

The demand feature might be primarily a form of protection or a tax-driven feature of the loan. Both parties might expect and intend that the loan will remain outstanding for the foreseeable future. If so, the instrument is, in substance, long-term in nature, and accordingly, OMN Ltd would classify the loan as a non-current asset.

However, OMN Ltd would classify the loan as a current asset if both the parties intend that it will be repaid within 12 months of the reporting period.

MN Ltd would classify the loan as current because it does not have the right to defer repayment for more than 12 months, regardless of the intentions of both the parties.

The classification of the instrument could affect initial recognition and subsequent measurement. This might require the entity's management to exercise judgement, which could require disclosure under judgements and estimates.

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1.15.2.5 Information to be provided in the Balance Sheet or in the notes

- An entity shall disclose, either in the balance sheet or in the notes, further sub-classifications of the line items presented, classified in a manner appropriate to the entity's operations.
- The detail provided in sub-classifications depends on the requirements of Ind AS and on the size, nature and function of the amounts involved.
- An entity shall disclose the following, either in the balance sheet or in the statement of changes in equity which is part of the balance sheet, or in the notes:

  (i) for each class of share capital:

    (a) the number of shares authorised;

    (b) the number of shares issued and fully paid, and issued but not fully paid;

    (c) par value per share, or that the shares have no par value;

    (d) a reconciliation of the number of shares

(e) the rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital;

(f) shares in the entity held by the entity or by its subsidiaries or associates; and

(g) shares reserved for issue under options and contracts for the sale of shares, including terms and amounts; and

(ii) a description of the nature and purpose of each reserve within equity.

- An entity whose capital is not limited by shares e.g., a company limited by guarantee, shall disclose information, showing changes during the period in each category of equity interest, and the rights, preferences and restrictions attaching to each category of equity interest.

Illustrated format of Balance Sheet Balance Sheet (with hypothetical figures given for ease in understanding)			₹ '000
	As at 31st March 20X6	**As at 31st March 20X5**	**As at 31st March 20X4**
Assets			
Non-Current Assets			
Property, Plant and equipment	1,37,048	97,023	88,145
Capital work in progress	17,450	3,100	0
Investment property	7,419	7,179	7,255
Goodwill	8,670	4,530	4,530
Other Intangible Assets	12,033	10,895	11,210
Intangible assets under development	2,365	1,965	960
Financial assets			
Investments	38,576	32,416	32,943
Loans	1,033	850	782
Trade Receivables	3,238	2,376	2,154
Deferred tax assets (net)	4,598	2,774	2,054
Other non-current assets	21,586	10,565	7,466
Total Non-Current Assets (A)	2,54,016	1,73,673	1,57,499
Current Assets			
Inventories	67,878	61,062	60,854

Financial assets			
Loans	623	546	548
Trade receivables	30,712	30,078	28,210
Derivative instruments			
Cash and cash equivalents	25,031	7,035	6,131
Investments	10,695	9,170	8,416
Other financial assets	2,856	2,093	1,052
Prepayments	459	543	366
	1,38,254	1,10,527	1,05,577
Assets classified as held for sale	220	19,310	
Total Current Assets (B)	1,38,474	1,29,837	1,05,577
Total Assets (A+B)	3,92,490	3,03,510	2,63,076

	As at 31st March 20X6	As at 31st March 20X5	As at 31st March 20X4
Equity and Liabilities			
Equity			
Equity share capital	22,400	12,600	12,000
Other Equity			
Equity component of compound financial instruments	372		
Reserves and surplus	2,16,092	1,60,796	1,28,893
Other reserves	4,233	3,215	2,420
Equity attributable to equity holders of the parent	2,43,097	1,76,611	1,43,313
Non-Controlling interest	24,742	16,248	14,109
Total equity (C)	2,67,839	1,92,859	1,57,422
Non-Current Liabilities			
Financial Liabilities			
Borrowings	41,455	35,565	36,537
Other financial liabilities	1,670	199	312
Long term provision	241	91	0

Deferred Income - Government grants		2,352	2,550	2,924
Contract liabilities				
Net employee defined benefit liabilities		7,296	5,076	4,945
Deferred tax liabilities (net)		12,085	9,864	7,776
Other non-current liabilities				
Total non-current liabilities	(D)	65,099	53,345	52,494
Current Liabilities				
Financial liabilities				
Borrowings		2,807	2,685	1,433
Trade payables (Other than micro enterprises and small enterprises)		38,011	28,977	34,195
Other current financial liabilities		8,909	8,837	10,825
Deferred Income - Government grants		938	1,017	1,166
Employee benefit obligations		430	378	256
Deferred revenue		4,152	3,986	3,950
Liabilities for current tax (net)		2,803	1,905	850
Provisions		1,502	531	485
Liabilities directly associated with the assets classified as held for distribution			8,990	
Total Current Liabilities	(E)	59,552	57,306	53,160
Total liabilities	(F=D+E)	1,24,651	1,10,651	1,05,654
Total equity and Liabilities	(C+F)	3,92,490	3,03,510	2,63,076

1.15.3 Statement of Profit and Loss

- The statement of profit and loss shall present, in addition to the profit or loss and other comprehensive income sections:
  - (a) profit or loss;
  - (b) total other comprehensive income;
  - (c) comprehensive income for the period, being the total of profit or loss and other comprehensive income.
- An entity shall present the following items as allocation of profit or loss and other comprehensive income for the period:
  - (a) profit or loss for the period attributable to:
    - (i) non-controlling interests, and

(ii) owners of the parent.

(b) comprehensive income for the period attributable to:

(i) non-controlling interests, and

(ii) owners of the parent.

1.15.3.1 Information to be presented in the profit or loss section of the Statement of Profit and Loss

In addition to items required by other Ind AS, the profit or loss section of the statement of profit and loss should include line items that present the following amounts for the period:

(a) revenue, presenting separately interest revenue calculated using the effective interest method;

(b) gains and losses arising from the derecognition of financial assets measured at amortised cost

(c) finance costs;

(d) impairment losses (including reversals of impairment losses or impairment gains) determined in accordance with Section 5.5 of Ind AS 109

(e) share of the profit or loss of associates and joint ventures accounted for using the equity method;

(f) if financial asset is reclassified out of the amortised cost measurement category so that it is measured at fair value through profit or loss, any gain or loss arising from a difference between the previous amortised cost of the financial asset and its fair value at the reclassification date;

(g) if a financial asset is reclassified out of the fair value through other comprehensive income measurement category so that it is measured at fair value through profit or loss, any cumulative gain or loss previously recognized in other comprehensive income that is reclassified to profit or loss

(h) tax expense;

(i) a single amount for the total discontinued operations

(j) share of the profit or loss of associates and joint ventures accounted for using the equity method

1.15.3.2 Information to be presented in the Other Comprehensive Income section

- The other comprehensive income section should present line items for the amounts of other comprehensive income classified by nature and grouped into those that, in accordance with other Ind AS:

  (i) will not be reclassified subsequently to profit or loss; and

  (ii) will be reclassified subsequently to profit or loss when specific conditions are met.

- An entity shall present additional line items, headings and subtotals in the statement of profit and loss, when such presentation is relevant to an understanding of the entity's financial performance.
- When an entity presents subtotals, those subtotals shall:
  (a) be comprised of line items made up of amounts recognised and measured in accordance with Ind AS;
  (b) be presented and labelled in a manner that makes the line items that constitute the subtotal clear and understandable;
  (c) be consistent from period to period; and
  (d) not be displayed with more prominence than the subtotals and totals required in Ind AS for the statement of profit and loss.
- An entity shall present the line items in the statement of profit and loss that reconcile any subtotals presented with the subtotals or totals required in Ind AS for such statement.
- An entity shall not present any items of income or expense as extraordinary items, in the statement of profit and loss or in the notes.

1.15.3.3 Profit or loss for the period

With regard to profit or loss for the period, the Standard requires the recognition of all items of income and expense in a period in profit or loss unless an Ind AS requires or permits otherwise.

Illustrative format of Statement of Profit and Loss

Statement of Profit and Loss for the year ended 31 March 20X6

	31 March 20X6	31 March 20X5
	₹ '000	₹ '000
Revenue from operations	6,33,124	4,86,316
Other Income	6,704	6,676
Total Income	**6,39,828**	**4,92,992**
Expenses		
Cost of raw material consumed	2,01,244	1,96,477
Purchase of stock-in-trade	56,300	51,700
(Increase)/decrease in inventories of goods	2,895	(2,587)
GST on sale of goods	42,685	37,785
Employee benefits expenses	80,998	69,962
Finance costs	3,085	2,963

Depreciation and amortisation expense	10,147	8,534
Impairment of non-current assets	480	790
Other expenses	15,308	9,065
Total Expense	**4,13,142**	**3,74,689**
Profit/(loss) before exceptional items and tax	2,26,686	1,18,303
Exceptional items	(2,856)	
Profit / (loss) before tax from operations	2,23,830	1,18,303
a) Current tax	5,388	4,474
b) Deferred tax	427	(746)
Income tax expense	5,815	3,728
Profit / (loss) for the year	2,18,015	1,14,575
Profit for the year attributable to		
Equity holders of the parent	2,11,475	1,11,138
Non-controlling interest	6,540	3,437

1.15.3.4 Other comprehensive income for the period

- With regard to other comprehensive income for the period, the Standard requires to disclose the amount of income tax relating to each item of other comprehensive income, including reclassification adjustments, either in the statement of profit and loss or in the notes.
- An entity may present items of other comprehensive income either:

  (a) net of related tax effects, or

  (b) before related tax effects with one amount shown for the aggregate amount of income tax relating to those items.
- The Standard further prescribes that an entity should disclose reclassification adjustments relating to components of other comprehensive income.
- Other Ind AS specify whether and when amounts previously recognised in other comprehensive income are reclassified to profit or loss. Such reclassifications are referred to in this Standard as reclassification adjustments.
- A reclassification adjustment is included with the related component of other comprehensive income in the period that the adjustment is reclassified to profit or loss.

Example

Gains realised on the disposal of financial assets are included in profit or loss of the current period. These amounts may have been recognised in other comprehensive income as unrealised gains in the current or previous periods. Those unrealised gains must be deducted from other comprehensive income in the period in which the realised gains are reclassified to profit or loss to avoid including them in total comprehensive income twice.

The following table depicts some of the items which are taken to OCI (numbers are illustrative only):

₹ lakhs

	Cash flow Hedge reserve	FVTOCI reserve	Foreign currency translation reserve	Revaluation reserve	Retained earnings	Total
Net Investment hedge			2,340			2,340
Foreign Exchange translation reserve			(2,950)			(2,950)
Currency Forward contracts	(7,680)					(7,680)
Reclassified to statement of profit or loss	3,385					3,385
Commodity forward contract	(1,850)					(1,850)
Gain / (loss) on FVTOCI financial assets		(480)				(480)
Re-measurement gains (losses) on defined benefit plans					3,085	3,085
Revaluation of land and buildings				7,100		7,100
	(6,145)	(480)	(610)	7,100	3,085	2,950

- An entity may present reclassification adjustments in the statement(s) of profit or loss and other comprehensive income or in the notes. An entity presenting reclassification adjustments in the notes presents the items of other comprehensive income after any related reclassification adjustments.
- Reclassification adjustments arise, for example, on disposal of a foreign operation (see Ind AS 21), and when some hedged forecast cash flow affect profit or loss (see Ind AS 109 in relation to cash flow hedges).
- Reclassification adjustments do not arise on changes in revaluation surplus recognised in accordance with Ind AS 16 or Ind AS 38 or on reameasurements of defined benefit plans recognised in accordance with Ind AS 19. These components are recognised in other comprehensive income and are not reclassified to profit or loss in subsequent periods. Changes in revaluation surplus may be transferred to retained earnings in subsequent periods as the asset is used or when it is derecognised (see Ind AS 16 and Ind AS 38). In accordance with Ind AS 109, reclassification adjustments do not arise if a cash flow hedge or the accounting for the time value of an option (or the forward element of a forward contract or the foreign currency basis spread of a financial instrument) result in amounts that are removed from the cash flow hedge reserve or a separate component of equity, respectively, and included directly in the initial cost or other carrying amount of an asset or a liability. These amounts are directly transferred to assets or liabilities.

Illustrative format of other Comprehensive Income

	31 March 20X6	31 March 20X5
	₹ '000	₹ '000
Other comprehensive income to be reclassified to profit and loss in subsequent periods		
Net gain on hedge of a net investment	467	300
Income tax effect	156	(100)
	623	**200**
Exchange differences on translation of foreign operations	(590)	(281)
Income tax effect	0	0
	(590)	**(281)**
Net movement on cash flow hedges	(1757)	80
Income tax effect	528	(22)
	(1229)	**58**
Net gain / (loss) through FVTOCI debt securities	(115)	7
Income tax effect	36	(2)
	(79)	**5**

Net other comprehensive income to be reclassified to profit or loss in subsequent periods	**(1275)**	**(18)**
Other comprehensive income not to be reclassified to profit or loss in subsequent periods		
Re-measurement gains /(losses) on defined benefit plans	886	(933)
Income tax effect	(269)	278
	617	**(655)**
Revaluation of land and building	2030	
Income tax effect	(610)	
	1420	**0**
Net loss / (gain) pm FVTOCI equity securities	(24)	
Income tax effect	7	
	(17)	
Net other comprehensive income not to be classified to profit or loss in subsequent periods	2020	(655)
Other comprehensive income for the year, net of tax	**745**	**-673**
Total comprehensive income for the year attributable to		
Equity holders of the parent	2,12,220	1,10,465
Non-controlling interest	6,540	3,437

1.15.3.5 Information to be presented in the Statement of Profit and Loss or in the Notes

- When items of income or expense are material, an entity shall disclose their nature and amount separately.
- Circumstances that would give rise to the separate disclosure of items of income and expense include:
  - (a) write-downs of inventories to net realisable value or of property, plant and equipment to recoverable amount, as well as reversals of such write-downs;
  - (b) restructurings of the activities of an entity and reversals of any provisions for the costs of restructuring;
  - (c) disposals of items of property, plant and equipment;
  - (d) disposals of investments;
  - (e) discontinued operations;
  - (f) litigation settlements; and
  - (g) other reversals of provisions.

- An entity shall present an analysis of expenses recognised in profit or loss using a classification based on the nature of expense method.

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

1.15.4 Statement of Changes in Equity

An entity shall present a statement of changes in equity which includes all changes in equity. It includes both - relating to performance and owner changes in equity (from transactions and events that increase or decrease equity, but are not part of performance). The statement of changes in equity includes the following information:

a. total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent and to non-controlling interests;

b. for each component of equity, the effects of retrospective application or retrospective restatement recognised in accordance with Ind AS 8;

c. for each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing each changes resulting from:

   - profit or loss;
   - each item of other comprehensive income;
   - transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control; and
   - any item recognised directly in equity such as amount recognised directly in equity as capital reserve with Ind AS 103.

1.15.4.1 Information to be presented in the statement of changes in equity or in the notes.

- An entity shall present, either in the statement of changes in equity or in the notes, an analysis of other comprehensive income by item.
- An entity shall present, either in the statement of changes in equity or in the notes, the amount of dividends recognised as distributions to owners during the period, and the related amount of dividends per share.
- Ind AS 8 requires retrospective adjustments to effect changes in accounting policies, to the extent practicable, except when the transition provisions in another Ind AS require otherwise. Ind AS 8 also requires restatements to correct errors to be made retrospectively, to the extent practicable. Retrospective adjustments and retrospective restatements are not changes in equity but they are adjustments to the opening balance of retained earnings, except when an Ind AS requires retrospective adjustment of another component of equity.
- Para 106(b) requires disclosure in the statement of changes in equity of the total adjustment to each component of equity resulting from changes in accounting policies and, separately, from corrections of errors. These adjustments are disclosed for each prior period and the beginning of the period.

Format of Statement of changes in equity for the year ended 31 March 20X6

₹

	Share capital	Translation reserve	Retained earnings	Total
Equity as at 31 March 20X5 (A)	1,041	(47,382)	2,65,266	2,18,925
Profit for the year			28,461	**28,461**
Other comprehensive income for the year		(3,399)	(5,535)	**(8,934)**
Total comprehensive income for the year (B)		(3,399)	22,926	**19,527**
Dividend paid to shareholders of the parent			(17,817)	**(17,817)**
Equity compensation plans			15	**15**
Reduction in share capital	(51)		(26,427)	**(26,478)**
Total transactions (C)	(51)		(44,229)	**(44,280)**
Equity as at 31 March, 20X6 (A+B+C)	990	(50,781)	2,43,963	1,94,172

1.15.5 Statement of Cash Flows

- Cash flow information provides users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows.
- An entity should present a statement of cash flows in accordance with Ind AS 7, Statement of Cash Flows.

1.15.6 Notes

1.15.6.1 Structure

The notes shall:

a. present information about the basis of preparation of the financial statements and the specific accounting policies used;

b. disclose the information required by Ind AS that is not presented elsewhere in the financial statements; and

c. provide information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them.

An entity shall present notes in a systematic manner. In determining a systematic manner, the entity shall consider the effect on the understandability and comparability of its financial statements.

An entity shall cross-reference each item in the balance sheet, in the statement of changes in equity which is a part of the balance sheet and in the statement of profit and loss, and statement of cash flows to any related information in the notes.

Examples of systematic ordering or grouping of the notes include following the order of the line items in the statement of profit and loss and the balance sheet, such as:

(a) giving prominence to the areas of its activities that the entity considers to be most relevant to an understanding of its financial performance and financial position, such as grouping together information about particular operating activities;

(b) grouping together information about items measured similarly such as assets measured at fair value; or

(c) following the order of the line items in the statement of profit and loss and the balance sheet, such as:

  (i) statement of compliance with Ind AS;

  (ii) significant accounting policies applied;

(iii) supporting information for items presented in the balance sheet and in the statement of profit and loss, and in the statements of changes in equity and of cash flows, in the order in which each statement and each line item is presented; and

(iv) other disclosures, including:

(1) contingent liabilities (see Ind AS 37) and unrecognised contractual commitments; and

(2) non-financial disclosures, eg the entity's financial risk management objectives and policies (see Ind AS 107).

An entity may present notes providing information about the basis of preparation of the financial statements and specific accounting policies as a separate section of the financial statements.

1.15.6.2 Disclosure of accounting policies

An entity shall disclose its significant accounting policies comprising:

a. the measurement basis (or bases) used in preparing the financial statements, and

b. the other accounting policies used that are relevant to an understanding of the financial statements.

An entity must disclose along with its significant accounting policies or other notes, the judgments, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements.

1.15.6.3 Sources of estimation uncertainty

An entity must disclose, in the notes, information about the assumptions made concerning the future, and other important sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. Disclosures about nature of such assets and their carrying amount as at the end of the reporting period should also be made.

1.15.6.4 Capital

An entity shall disclose information that enables users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital.

Example

For the purpose of the Group's capital management, capital includes issued equity capital, convertible preference shares, share premium and all other equity reserves attributable to the equity holders of the parent. The primary objective of the Group's capital management is to maximise the shareholder value.

The Group manages its capital structure and makes adjustments in light of changes in economic conditions and the requirements of the financial covenants. To maintain or adjust the capital structure, the Group may adjust the dividend payment to shareholders, return capital to shareholders or issue new shares. The Group monitors capital using a gearing ratio, which is net debt divided by total capital plus net debt. The Group's policy is to keep the gearing ratio between 20% and 40%. The Group includes within net debt, interest bearing loans and borrowings, trade and other payables, less cash and cash equivalents, excluding discontinued operations.

₹

	31 March 20X6	31 March 20X5	31 March 20X4
Borrowings other than convertible preference shares	1,44,201	1,57,506	1,54,692
Trade payables	1,26,489	1,36,563	1,25,778
Other payables	13,506	12,693	13,506
Less : Cash and cash equivalents	(1,18,362)	(1,05,615)	(79,674)
Net debt	**1,65,834**	**2,01,147**	**2,14,302**
Convertible preference shares	20,001	19,038	19,038
Equity	4,29,600	3,37,000	3,04,000
Total Capital	**4,49,601**	**3,56,038**	**3,23,038**
Capital and net debt	**6,15,435**	**5,57,185**	**5,37,340**
Gearing ratio	27	36	40

In order to achieve this overall objective, the Group's capital management, amongst other things, aims to ensure that it meets financial covenants attached to the interest-bearing loans and borrowings that define capital structure requirements. Breaches in meeting the financial covenants would permit the bank to immediately call loans and borrowings. There have been no breaches in the financial covenants of any interest-bearing loans and borrowing in the current period. No changes were made in the objectives, policies or processes for managing capital during the years ended 31 March 20X6 and 31 March 20X5.

Example

Capital Allocation Policy: The Board reviewed and approved a revised Capital Allocation Policy of the Company after taking into consideration the strategic and operational cash requirements of the Company in the medium term. The key aspects of the Capital Allocation Policy are:1. The Company's current policy is to pay dividends of up to 50% of post-tax profits of the Financial Year. Effective from Financial Year 2018, the Company expects to payout up to 70% of the free cash flow* of the corresponding Financial Year in such manner (including by way of dividend and/or share buyback) as may be decided by the Board from time to time, subject to applicable laws and requisite approvals, if any.2. In addition to the above, the Board has identified an amount of upto ₹ 13,000 crore ($2 billion)** to be paid out to shareholders during Financial Year 2018, in such manner (including by way of dividend and/ or share buyback), to be decided by the Board, subject to applicable laws and requisite approvals, if any. Further announcements in this regard will be made, as appropriate, in due course

* Free cash flow is defined as net cash provided by operating activities less capital expenditure as per the consolidated statement of cash flows prepared under Ind AS USD/Rupee exchange rate as on March 31, 2017. Dividend payout includes Dividend Distribution Tax.

Example

The groups objective when managing capital are

- Safeguard their ability to continue as a going concern, so that they can continue to provide returns for shareholders and benefits for other stakeholders, and
- Maintain an optimum capital structure to reduce the cost of capital

In order to maintain or adjust the capital structure, the group may adjust the amounts of dividends paid to shareholders, return capital to shareholders, issue new shares or sell assets to reduce debt. Consistent with others in the industry, the group monitors capital on the basis of the following gearing ratio: Net debt divided by the Total equity (as shown in balance sheet including Non-controlling Interest)

During 20X5, the group's strategy which was unchanged from 20X4 was to maintain a gearing ratio within 20% to 30% and A credit rating. The credit rating was unchanged and the gearing ratio was within the limits as follows

	31 March 20X5	31 March 20X4
Net debt	3,384	3,447
Total equity	16,035	11,762
Net debt to equity	21%	29%

1.15.6.5 Puttable financial instruments classified as equity

For puttable financial instruments classified as equity instruments, an entity shall disclose (to the extent not disclosed elsewhere):

a. summary quantitative data about the amount classified as equity;

b. its objectives, policies and processes for managing its obligation to repurchase or redeem the instruments when required to do so by the instrument holders, including any changes from the previous period;

c. the expected cash outflow on redemption or repurchase of that class of financial instruments; and

d. information about how the expected cash outflow on redemption or repurchase was determined.

1.15.6.6 Other disclosures

An entity must disclose the amount of dividends proposed or declared before the financial statements were approved for issue but not recognised as a distribution to owners during the period, and the related amount per share and the amount of any cumulative preference dividends not recognised.

Ind AS 1 requires certain other disclosures, if not disclosed elsewhere in information published with the financial statements:

a) the domicile and legal form of the entity, its country of incorporation and the address of its registered office (or principal place of business, if different from the registered office);

b) a description of the nature of the entity's operations and its principal activities;

c) the name of the parent and the ultimate parent of the group; and

d) if it is a limited life entity, information regarding the length of its life.

Illustration 16

A Limited has prepared the following draft balance sheet as on 31st March 20X1: **(₹ in crores)**

Particulars	***March 31, 20X1***	***March 31, 20X0***
ASSETS		
Cash	250	170
Cash equivalents	70	30
Non-controlling interest's share of profit for the year	160	150
Dividend declared by A Limited	90	70
Accounts receivable	2,300	1,800
Inventory at cost	1,500	1,650
Inventory at fair value less cost to complete and sell	180	130
Investment property	3,100	3,100
Property, plant and equipment (PPE) at cost	5,200	4,700
Total	***12,850***	***11,800***
CLAIMS AGAINST ASSETS		
Long term debt (₹ 500 crores due on 1st January each year)	3,300	3,885
Interest accrued on long term debt (due in less than 12 months)	260	290
Share Capital	1,130	1,050
Retained earnings at the beginning of the year	1,875	1,740

Profit for the year	*1,200*	*830*
Non-controlling interest	*830*	*540*
Accumulated depreciation on PPE	*1,610*	*1,240*
Provision for doubtful receivables	*200*	*65*
Trade payables	*880*	*790*
Accrued expenses	*15*	*30*
Warranty provision (for 12 months from the date of sale)	*600*	*445*
Environmental restoration provision (restoration expected in 20X6)	*765*	*640*
Provision for accrued leave (due within 12 months)	*35*	*25*
Dividend payable	*150*	*230*
Total	***12,850***	***11,800***

Prepare a balance sheet using current and non-current classification in accordance with Ind AS 1. Assume operating cycle is 12 months.

Solution

A Limited
Balance Sheet as at 31st March 20X1

(₹ in crores)

Particulars	**Note**	**March 31, 20X1**	**March 31, 20X0**
ASSETS			
Non-current assets			
(a) Property, plant and equipment	1	3,590	3,460
(b) Investment property		3,100	3,100
Total non-current assets		**6,690**	**6,560**
Current assets			
(a) Inventory	2	1,680	1,780
(b) Financial assets			
Trade and other receivables	3	2,100	1,735
Cash and cash equivalents	4	320	200
Total current assets		**4,100**	**3,715**
Total assets		**10,790**	**10,275**
EQUITY & LIABILITIES			
Equity attributable to owners of the parent			
Share capital		1,130	1,050

Other Equity	5	2,825	2,350
Non-controlling interests		**830**	**540**
Total equity		**4,785**	**3,940**
LIABILITIES			
Non-current liabilities			
(a) Financial Liabilities			
(i) Borrowings - Long-term debt	6	2,800	3,385
(b) Provisions			
Long-term provisions (environmental restoration)		765	640
Total non-current liabilities		**3,565**	**4,025**
Current liabilities			
(a) Financial Liabilities			
(i) Trade and other payables	7	895	820
(ii) Current portion of long-term debt	8	500	500
(iii) Interest accrued on long-term debt		260	290
(iv) Dividends payable		150	230
(b) Provisions			
(i) Warranty provision		600	445
(ii) Other short-term provisions		35	25
Total current liabilities		**2,440**	**2,310**
Total liabilities		**6,005**	**6,335**
Total equity and liabilities		**10,790**	**10,275**

Working Notes:

Notes	Particulars	Basis	Calculation ₹ crores	Amount ₹ crores
1	Property, plant and equipment	Property, plant and equipment (PPE) at cost *less* Accumulated (depreciation on PPE	5,200 – 1,610 (4,700 – 1,240)	3,590 (3,460)
2	Inventory	Inventory at cost *add* Inventory at fair value less cost to complete and sell	1,500 + 180 (1,650 + 130)	1,680 (1,780)
3	Trade and other receivables	Accounts receivable *less* Provision for doubtful receivables	2,300 – 200 (1,800 – 65)	2,100 (1,735)

4	Cash and cash equivalents	Cash and Cash equivalents	250 + 70 (170 + 30)	320 (200)
5	Other Equity	Retained earnings at the beginning of the year *add* Profit for the year *less* Non-controlling interest's share of profit for the year *less* Dividend declared by A Limited	1,875 + 1,200– 160 – 90 (1,740 + 830 – 150 – 70)	2,825 (2,350)
6	Long-term debt	Long-term debt *less* Due on 1st January each year	3,300 – 500 (3,885 – 500)	2,800 (3,385)
7	Trade & other payables	Trade payables *add* Accrued expenses	880 + 15 (790 + 30)	895 (820)
8	Current portion of long- term debt	Due on 1st January each year	- -	500 (500)

Note: Figures in brackets represent the figures for comparative year.

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1.16 SIGNIFICANT DIFFERENCES IN IND AS 1 VIS-À-VIS AS 1

Ind AS 1 deals with presentation of financial statements, whereas AS 1 deals only with the disclosure of accounting policies. The scope of Ind AS 1 is thus much wider and line by line comparison of the differences with the existing standard is not possible. However, the major requirements as laid down in Ind AS 1 are as follows:

S. No.	Particulars	Ind AS 1	AS 1
1.	*Explicit Statement of Compliance*	An enterprise shall make an explicit statement in the financial statements of compliance with all the Indian Accounting Standards. Further, Ind AS 1 allows deviation from a requirement of an accounting standard in case the management concludes that compliance with Ind AS will be misleading and if the	No such guidance given in AS 1

S. No.	Particulars	Ind AS 1	AS 1
		regulatory framework requires or does not prohibit such a departure.	
2.	*Current and Non-current Classification*	Ind AS 1 requires presentation and provides criteria for classification of Current / Non-Current assets / liabilities	
3.	*Extraordinary Items*	Ind AS 1 prohibits presentation of any item as 'Extraordinary Item' in the statement of profit and loss or in the notes	
4.	*Disclosure of Judgements and Assumptions made*	Ind AS 1 requires disclosure of judgments made by management while framing of accounting policies. Also, it requires disclosure of key assumptions about the future and other sources of measurement of uncertainty that have significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within next financial year	
5.	*Classification of Expenses*	Ind AS 1 requires classification of expenses to be presented based on nature of expenses.	
6.	*Comparative Balance Sheets*	Ind AS 1 requires presentation of balance sheet as at the beginning of the earliest period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in the financial statements, or when it reclassifies items in its financial statements.	
7.	*Disclosure of Reclassified Items*	In respect of reclassification of items, Ind AS 1 requires disclosure of nature, amount and reason for reclassification in the notes to financial statements.	
8.	*Statement of Changes in Equity*	Ind AS 1 requires the financial statements to include a Statement of Changes in Equity to be	

S. No.	Particulars	Ind AS 1	AS 1
		shown as a separate statement, which, inter alia, includes reconciliation between opening and closing balance for each component of equity.	
9.	*Statement of Other Comprehensive Income*	Ind AS 1 requires that an entity shall present a single statement of profit and loss, with profit or loss and other comprehensive income presented in two sections. The sections shall be presented together, with the profit or loss section presented first followed directly by the other comprehensive income section.	
10.	*Inclusion of Comparative Information*	As per Ind AS 1, an entity shall include certain comparative information for understanding the current period's financial statements.	
11.	*Classification of Long-term Loan Arrangement*	Ind AS 1 clarifies that long term loan arrangement need not be classified as current on account of breach of a material provision, for which the lender has agreed to waive before the approval of financial statements for issue.	

1.17 CARVE OUT IN IND AS 1 FROM IAS 1

As per IFRS

IAS 1 requires that in case of a loan liability, if any condition of the loan agreement which was classified as non -current is breached on the reporting date, such loan liability should be classified as current, even if the breach is rectified after the balance sheet date.

Carve Out

Ind AS 1 clarifies that where there is a breach of a material provision 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 on the reporting date, the entity does not classify the liability as current, if the lender agreed, after the reporting period and before the approval of the financial statements for issue, not to demand payment as a consequence of the breach.

Reason

Under Indian banking system, a long-term loan agreement generally contains a large number of conditions. Some of these conditions are substantive, such as, recalling the loan in case interest is not paid, and some conditions are procedural and not substantive, such as, submission of insurance details where the entity has taken the insurance but not submitted the details to the lender at the end of the reporting period. Generally, customer-banker relationships are developed whereby in case of any procedural breach, a loan is generally not recalled. Also, in many cases, a breach is rectified after the balance sheet date and before the approval of financial statements. Carve out has been made as it is felt that if the breach is rectified after the balance sheet date and before the approval of the financial statements, it would be appropriate that the users are informed about the true nature of liabilities being non-current liabilities and not current liabilities.

TEST YOUR KNOWLEDGE

Questions

1. An entity manufactures passenger vehicles. The time between purchasing of underlying raw materials to manufacture the passenger vehicles and the date the entity completes the production and delivers to its customers is 11 months. Customers settle the dues after a period of 8 months from the date of sale.

   (a) Will the inventory and the trade receivables be current in nature?

   (b) Assuming that the production time was say 15 months and the time lag between the date of sale and collection from customers is 13 months, will the answer be different?

2. In December 2XX1 an entity entered into a loan agreement with a bank. The loan is repayable in three equal annual instalments starting from December 2XX5. One of the loan covenants is that an amount equivalent to the loan amount should be contributed by promoters by March 24 2XX2, failing which the loan becomes payable on demand. As on March 24, 2XX2, the entity has not been able to get the promoter's contribution. On March 25, 2XX2, the entity approached the bank and obtained a grace period upto June 30, 2XX2 to get the promoter's contribution.

   The bank cannot demand immediate repayment during the grace period. The annual reporting period of the entity ends on March 31.

   (a) As on March 31, 2XX2, how should the entity classify the loan?

   (b) Assume that in anticipation that it may not be able to get the promoter's contribution by due date, in February 2XX2, the entity approached the bank and got the compliance date extended upto June 30, 2XX2 for getting promoter's contribution. In this case will the loan classification as on March 31, 2XX2 be different from (a) above?

3. Company A has taken a long term loan from Company B. In the month of December 20X1, there has been a breach of material provision of the arrangement. As a consequence of which the loan becomes payable on demand on March 31, 20X2. In the month of May 20X2, the Company started negotiation with the Company B for not to demand payment as a consequence of the breach. The financial statements were approved for the issue in the month of June 20X2. In the month of July 20X2, both the companies agreed that the payment will not be demanded immediately as a consequence of breach of material provision.

   Advise on the classification of the liability as current / non –current.

4. Entity A has undertaken various transactions in the financial year ended March 31, 20X1. Identify and present the transactions in the financial statements as per Ind AS 1.

₹

Remeasurement of defined benefit plans	2,57,000
Current service cost	1,75,000
Changes in revaluation surplus	1,25,000
Gains and losses arising from translating the monetary assets in foreign currency	75,000
Gains and losses arising from translating the financial statements of a foreign operation	65,000
Gains and losses from investments in equity instruments designated at fair value through other comprehensive income	1,00,000
Income tax expense	35,000
Share based payments cost	3,35,000

Answers

1. Inventory and debtors need to be classified in accordance with the requirement of Ind AS 1, which provides that an asset shall be classified as current if an entity expects to realise the same, or intends to sell or consume it in its normal operating cycle.

(a) In this case, time lag between the purchase of inventory and its realisation into cash is 19 months [11 months + 8 months]. Both inventory and the debtors would be classified as current if the entity expects to realise these assets in its normal operating cycle.

(b) No, the answer will be the same as the classification of debtors and inventory depends on the expectation of the entity to realise the same in the normal operating cycle. In this case, time lag between the purchase of inventory and its realisation into cash is 28 months [15 months + 13 months]. Both inventory and debtors would be classified as current if the entity expects to realise these assets in the normal operating cycle.

2. (a) Ind AS 1, inter alia, provides, "An entity classifies 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 twelve months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment." In the present case, following the default, grace period within which an entity can rectify the breach is less than twelve months after the reporting period. Hence as on March 31, 2XX2, the loan will be classified as current.

(b) Ind AS 1 deals with classification of liability as current or non-current in case of breach of a loan covenant and does not deal with the classification in case of expectation of breach. In this case, whether actual breach has taken place or not is to be assessed on June 30, 2XX2, i.e., after the reporting date. Consequently, in the absence of actual breach of the loan covenant as on March 31, 2XX2, the loan will retain its classification as non-current.

3. As per para 74 of Ind AS 1 "Presentation of Financial Statements" where there is a breach of a material provision 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 period and before the authorization of the financial statements for issue, not to demand payment as a consequence of the breach.

However, an entity classifies 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 twelve months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment.

In the given case, Company B (the lender) agreed for not to demand payment but only after the reporting date and the financial statements were approved for issuance. The financial statements were approved for issuance in the month of June 20X2 and both companies agreed for not to demand payment in the month of July 20X2 although negotiation started in the month of May 20X2 but could not agree before June 20X2 when financial statements were approved for issuance.

Hence, the liability should be classified as current in the financial statement as at March 31, 20X2.

4. Items impacting the Statement of Profit and Loss for the year ended 31st March, 20X1 (₹)

Current service cost	1,75,000
Gains and losses arising from translating the monetary assets in foreign currency	75,000
Income tax expense	35,000
Share based payments cost	3,35,000

Items impacting the other comprehensive income for the year ended 31st March, 20X1 (₹)

Remeasurement of defined benefit plans	2,57,000
Changes in revaluation surplus	1,25,000
Gains and losses arising from translating the financial statements of a foreign operation	65,000
Gains and losses from investments in equity instruments designated at fair value through other comprehensive income	1,00,000

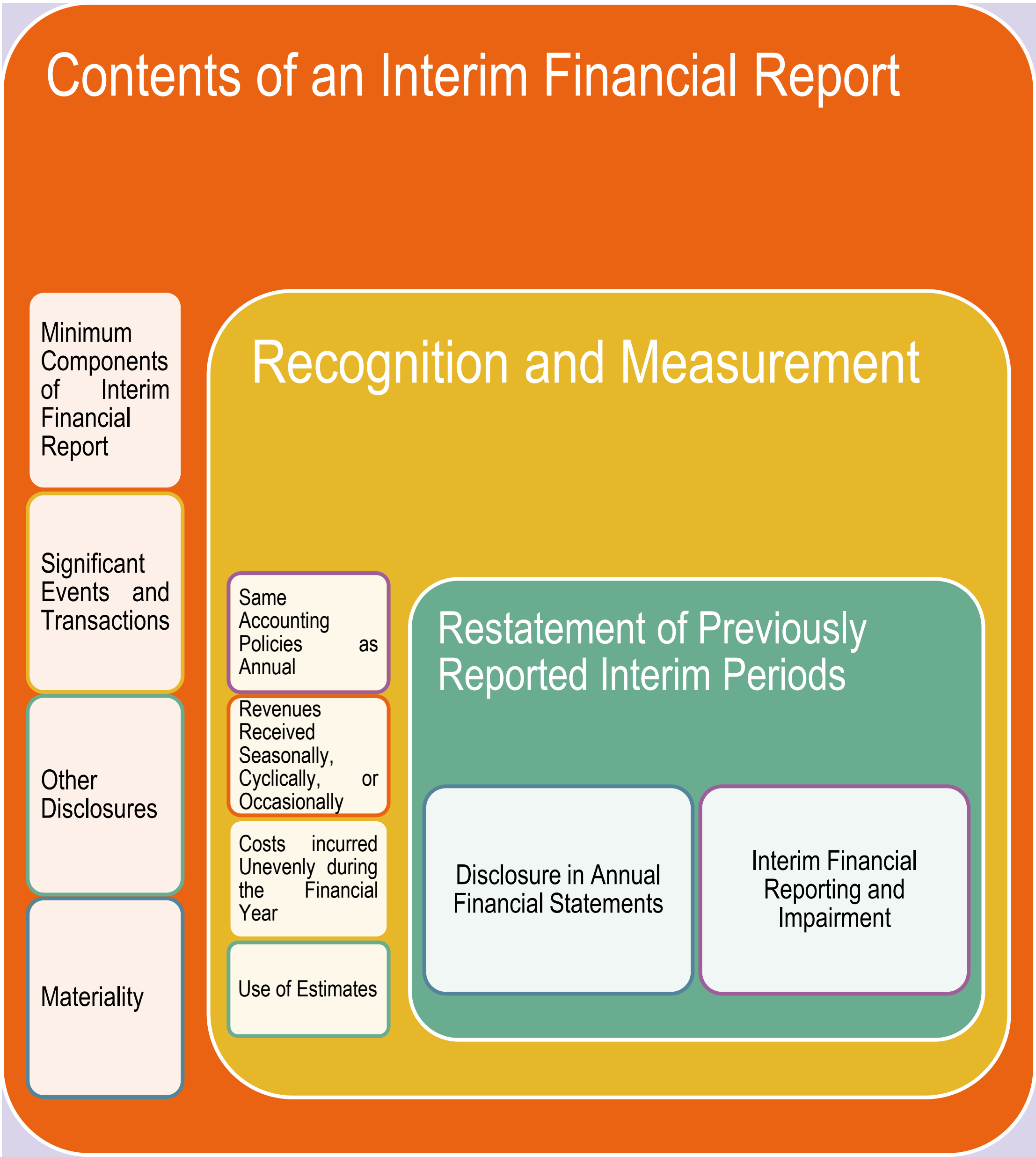
UNIT 2: INDIAN ACCOUNTING STANDARD 34: INTERIM FINANCIAL REPORTING

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand the objective and scope of Ind AS 34
- Define the relevant terms used in the standard
- Elaborate the contents of interim financial report
- Prescribe minimum content of Interim Financial Report
- Include significant events and transactions while preparing the interim financial report
- Prescribe principles of recognition and measurement in complete or condensed Financial statement for an interim period
- Prepare the interim financial report of an entity
- Differentiate between Ind AS 34 and AS 25.

UNIT OVERVIEW



2.1 INTRODUCTION

Interim Financial Reporting applies when an entity prepares an interim financial report. Ind AS 34 does not mandate an entity as when to prepare such a report. Timely and reliable interim financial reporting improves the ability of investors, creditors, and others to understand an entity's capacity to generate earnings and cash flows and its financial condition and liquidity. Permitting less information to be reported than in annual financial statements (on the basis of providing an update to those financial statements), the standard outlines the recognition, measurement and disclosure requirements for interim reports.

2.2 OBJECTIVE

The objective of this Standard is to prescribe

a) the minimum content of an interim financial report

b) the principles for recognition and measurement in complete or condensed financial statements for an interim period.

2.3 SCOPE

- This Standard does not mandate which entities should be required to publish interim financial reports, how frequently, or how soon after the end of an interim period.
- This Standard applies if an entity is required or elects to publish an interim financial report in accordance with Indian Accounting Standards (Ind AS).
- Each financial report, annual or interim, is evaluated on its own for conformity to Ind AS. The fact that an entity may not have provided interim financial reports during a particular financial year or may have provided interim financial reports that do not comply with this Standard does not prevent the entity's annual financial statements from conforming to Ind AS if they otherwise do so.
- If an entity's interim financial report is described as complying with Ind AS, it must comply with all of the requirements of this Standard.

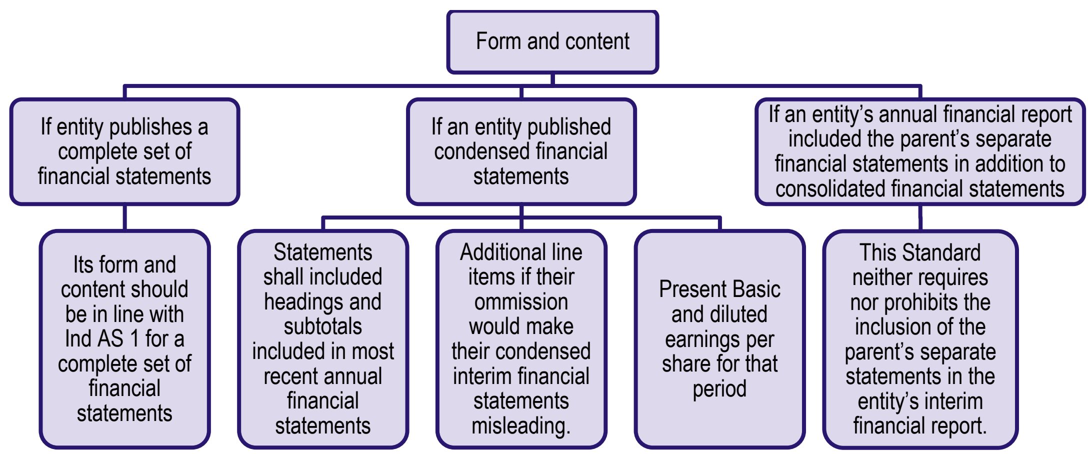
2.4 DEFINITIONS

1. **Interim period** is a financial reporting period shorter than a full financial year.
2. **Interim financial report** means a financial report containing either a complete set of financial statements (as described in Ind AS 1, Presentation of Financial Statements), or a set of condensed financial statements (as described in this Standard) for an interim period.

2.5 CONTENTS OF AN INTERIM FINANCIAL REPORT

- An Interim Financial Report shall include, at minimum, the following:
  - A condensed balance sheet
  - A condensed statement of profit and loss
  - A condensed statement of changes in equity
  - A condensed statement of cash flows
  - Notes, comprising significant accounting policies and other explanatory information
- In the interest of timeliness and cost considerations and to avoid repetition of information previously reported, an entity may be required to or may elect to provide less information at interim dates as compared with its annual financial statements.
- The interim financial report focuses on new activities, events, and circumstances and does not duplicate information previously reported.
- Nothing in this Standard is intended to prohibit or discourage an entity from publishing a complete set of financial statements (as described in Ind AS 1) in its interim financial report, rather than condensed financial statements and selected explanatory notes. Nor does this Standard prohibit or discourage an entity from including in condensed interim financial statements more than the minimum line items or selected explanatory notes as set out in this Standard.

2.5.1 Form and Content of Interim financial report



2.5.2 Significant events and transactions

- An entity shall include in its interim financial report an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period.
- Information disclosed in relation to those events and transactions shall update the relevant information presented in the most recent annual financial report.
- A user of an entity's interim financial report will have access to the most recent annual financial report of that entity. Therefore, it is unnecessary for the notes to an interim financial report to provide relatively insignificant updates to the information that was reported in the notes in the most recent annual financial report.

The following is a list of events and transactions for which disclosures would be required if they are significant: the list is not exhaustive.
1. the write-down of inventories to net realisable value and the reversal of such write-down;
2. recognition of a loss from the impairment of financial assets, property, plant and equipment, intangible assets, assets arising from contracts with customers, or other assets, and the reversal of such an impairment loss;
3. the reversal of any provisions for the costs of restructuring;
4. acquisitions and disposals of items of property, plant and equipment;
5. commitments for the purchase of property, plant and equipment;
6. litigation settlements;
7. corrections of prior period errors;
8. changes in the business or economic circumstances that affect the fair value of the entity's financial assets and financial liabilities, whether those assets or liabilities are recognised at fair value or amortised cost;
9. any loan default or breach of a loan agreement that has not been remedied on or before the end of the reporting period;
10. related party transactions;
11. transfers between levels of the fair value hierarchy used in measuring the fair value of financial instruments;
12. changes in the classification of financial assets as a result of a change in the purpose or use of those assets; and
13. changes in contingent liabilities or contingent assets.

- Individual Ind AS provide guidance regarding disclosure requirements for many of the items listed above. When an event or transaction is significant to an understanding of the changes in an entity's financial position or performance since the last annual reporting period, its interim financial report should provide an explanation of and an update to the relevant information included in the financial statements of the last annual reporting period.

2.5.3 Other disclosures

The information shall normally be reported on a financial year-to-date basis. In addition to disclosing significant events and transactions, an entity shall include the following information, in the notes to its interim financial statements. The following disclosures shall be given either in the interim financial statements or incorporated by cross-reference from the interim financial statements to some other statement (such as management commentary or risk report) that is available to users of the financial statements on the same terms as the interim financial statements and at the same time. If users of the financial statements do not have access to the information incorporated by cross-reference on the same terms and at the same time, the interim financial report is incomplete.

a)	a statement that the same accounting policies and methods of computation are followed in the interim financial statements. If those recently used policies or methods have been changed, a description of the nature and effect of the change should also be given.
b)	explanatory comments about the seasonality or cyclicality of interim operations.
c)	the nature and amount of items affecting assets, liabilities, equity, net income or cash flows that are unusual because of their nature, size or incidence.
d)	the nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years.
e)	issues, repurchases and repayments of debt and equity securities.
f)	dividends paid (aggregate or per share) separately for ordinary shares and other shares.
g)	the following segment information (disclosure of segment information is required in an entity's interim financial report only if Ind AS 108, *Operating Segments,* requires that entity to disclose segment information in its annual financial statements): i. revenues from external customers, if included in the measure of segment profit or loss reviewed by the chief operating decision maker or otherwise regularly provided to the chief operating decision maker. ii. intersegment revenues, if included in the measure of segment profit or loss reviewed by the chief operating decision maker or otherwise regularly provided to the chief operating decision maker. iii. a measure of segment profit or loss.

	iv. a measure of total assets and liabilities for a particular reportable segment if such amounts are regularly provided to the chief operating decision maker and if there has been a material change from the amount disclosed in the last annual financial statements for that reportable segment. v. a description of differences from the last annual financial statements in the basis of segmentation or in the basis of measurement of segment profit or loss. vi. a reconciliation of the total of the reportable segments' measures of profit or loss to the entity's profit or loss before tax expense (tax income) and discontinued operations. However, if an entity allocates to reportable segments items such as tax expense (tax income), the entity may reconcile the total of the segments' measures of profit or loss to profit or loss after those items. Material reconciling items shall be separately identified and described in that reconciliation.
h)	events after the interim period that have not been reflected in the financial statements for the interim period.
i)	the effect of changes in the composition of the entity during the interim period, including business combinations, obtaining or losing control of subsidiaries and long-term investments, restructurings, and discontinued operations. In the case of business combinations, the entity shall disclose the information required by Ind AS 103, *Business Combinations*.
j)	for financial instruments, the disclosures about fair value of Ind AS 113, *Fair Value Measurement,* and Ind AS 107, *Financial Instruments: Disclosures*.
k)	for entities becoming, or ceasing to be, investment entities, as defined in Ind AS 110, *Consolidated Financial Statements*, the disclosures in Ind AS 112, *Disclosure of Interests in Other Entities*.
l)	the disaggregation of revenue from contracts with customers required by Ind AS 115, *Revenue from Contracts with Customers*.

2.5.4 Periods for which interim financial statements are required to be presented

Interim reports shall include interim financial statements (condensed or complete) for periods as follows:

(a) balance sheet as of the end of the current interim period and a comparative balance sheet as of the end of the immediately preceding financial year.

(b) statements of profit and loss for the current interim period and cumulatively for the current financial year to date, with comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year.

(c) statement of changes in equity cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

(d) statement of cash flows cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

For an entity whose business is highly seasonal, financial information for the twelve months up to the end of the interim period and comparative information for the prior twelve-month period may be useful.

2.5.5 Materiality

- In deciding how to recognise, measure, classify, or disclose an item for interim financial reporting purposes, materiality shall be assessed in relation to the interim period financial data.
- In making assessments of materiality, it shall be recognised that interim measurements may rely on estimates to a greater extent than measurements of annual financial data.
- While judgement is always required in assessing materiality, this Standard bases the recognition and disclosure decision on data for the interim period by itself for reasons of understandability of the interim figures.
- Unusual items, changes in accounting policies or estimates, and errors are recognised and disclosed on the basis of materiality in relation to interim period data to avoid misleading inferences that might result from non-disclosure.

2.6 DISCLOSURE IN ANNUAL FINANCIAL STATEMENTS

- If an estimate of an amount reported in an interim period is changed significantly during the final interim period of the financial year but a separate financial report is not published for that final interim period, the nature and amount of that change in estimate shall be disclosed in a note to the annual financial statements for that financial year.
- Ind AS 8 requires disclosure of the nature and (if practicable) the amount of a change in estimate that either has a material effect in the current period or is expected to have a material effect in subsequent periods.
- An entity is not required to include additional interim period financial information in its annual financial statements.

2.7 RECOGNITION AND MEASUREMENT

S. No.	Criteria	Recognition and Measurement
1	Same accounting	1. An entity shall apply the same accounting policies in its

	policies as annual	interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. 2. The frequency of an entity's reporting (annual, half-yearly, or quarterly) shall not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes shall be made on a year-to-date basis. 3. Year-to-date measurements may involve changes in estimates of amounts reported in prior interim periods of the current financial year. But the principles for recognising assets, liabilities, income, and expenses for interim periods are the same as in annual financial statements.
2	Revenues received cyclically, occasionally or seasonally	1. Revenues that are received seasonally, cyclically, or occasionally within a financial year shall not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the entity's financial year. Examples include dividend revenue, royalties, and government grants. 2. Certain entities earn more revenue in certain interim periods of a financial year than other interim periods. Such revenues are recognised when they occur. Example seasonal revenues of retailers.
3	Costs incurred unevenly during the financial year	Costs that are incurred unevenly during an entity's financial year shall be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year.

Examples:

Employer payroll taxes and insurance contributions

If employer payroll taxes or contributions to government-sponsored insurance funds are assessed on an annual basis, the employer's related expense is recognised in interim periods using an estimated average annual effective payroll tax or contribution rate, even though a large portion of the payments may be made early in the financial year. A common example is an employer payroll tax or insurance contribution that is imposed up to a certain maximum level of earnings per employee. For higher income employees, the maximum income is reached before the end of the financial year, and the employer makes no further payments through the end of the year.

Major planned periodic maintenance or overhaul

The cost of a planned major periodic maintenance or overhaul or other seasonal expenditure that is expected to occur late in the year is not anticipated for interim reporting purposes unless an event has caused the entity to have a legal or constructive obligation. The mere intention or necessity to incur expenditure related to the future is not sufficient to give rise to an obligation.

Provisions

A provision is recognised when an entity has no realistic alternative but to make a transfer of economic benefits as a result of an event that has created a legal or constructive obligation. The amount of the obligation is adjusted upward or downward, with a corresponding loss or gain recognised in profit or loss, if the entity's best estimate of the amount of the obligation changes.

This Standard requires that an entity apply the same criteria for recognising and measuring a provision at an interim date as it would at the end of its financial year. The existence or non-existence of an obligation to transfer benefits is not a function of the length of the reporting period. It is a question of fact.

Year-end bonuses

The nature of year-end bonuses varies widely. Some are earned simply by continued employment during a time period. Some bonuses are earned based on a monthly, quarterly, or annual measure of operating result. They may be purely discretionary, contractual, or based on years of historical precedent.

A bonus is anticipated for interim reporting purposes if, and only if, (a) the bonus is a legal obligation or past practice would make the bonus a constructive obligation for which the entity has no realistic alternative but to make the payments, and (b) a reliable estimate of the obligation can be made. Ind AS 19, *Employee Benefits* provides guidance.

Variable lease payments

Contingent lease payments can be an example of a legal or constructive obligation that is recognised as a liability. If a lease provides for contingent payments based on the lessee achieving a certain level of annual sales, an obligation can arise in the interim periods of the financial year before the required annual level of sales has been achieved, if that required level of sales is expected to be achieved and the entity, therefore, has no realistic alternative but to make the future lease payment.

Intangible assets

An entity will apply the definition and recognition criteria for an intangible asset in the same way in an interim period as in an annual period. Costs incurred before the recognition criteria for an intangible asset are met, are recognised as an expense. Costs incurred after the specific point in time at which the criteria are met are recognised as part of the cost of an intangible asset. 'Deferring' costs as assets in an interim balance sheet in the hope that the recognition criteria will be met later in the financial year is not justified.

Vacations, holidays, and other short-term compensated absences

Accumulating compensated absences are those that are carried forward and can be used in future periods if the current period's entitlement is not used in full. Ind AS 19, *Employee Benefits* requires that an entity measure the expected cost of and obligation for accumulating compensated absences at the amount the entity expects to pay as a result of the unused entitlement that has accumulated at the end of the reporting period. That principle is also applied at the end of interim financial reporting periods. Conversely, an entity recognises no expense or liability for non-accumulating compensated absences at the end of an interim reporting period, just as it recognises none at the end of an annual reporting period.

Other planned but irregularly occurring costs

An entity's budget may include certain costs expected to be incurred irregularly during the financial year, such as charitable contributions and employee training costs. Those costs generally are discretionary even though they are planned and tend to recur from year to year. Recognising an obligation at the end of an interim financial reporting period for such costs that have not yet been incurred generally is not consistent with the definition of a liability.

Measuring interim income tax expense

Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period.

This is consistent with the basic concept set out in the Standard that the same accounting recognition and measurement principles shall be applied in an interim financial report as are applied in annual financial statements. Income taxes are assessed on an annual basis. Interim period income tax expense is calculated by applying to an interim period's pre-tax income the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate. That estimated average annual rate would reflect a blend of the progressive tax rate structure expected to be applicable to the full year's earnings including enacted or substantively enacted changes in the income tax rates scheduled to take effect later in the financial year. Ind AS 12, *Income Taxes* provides guidance on substantively enacted changes in tax rates. The estimated average annual income tax rate would be re-estimated on a year-to-date basis, consistent with paragraph 28 of this Standard. The Standard requires disclosure of a significant change in estimate.

To the extent practicable, a separate estimated average annual effective income tax rate is determined for each taxing jurisdiction and applied individually to the interim period pre-tax income of each jurisdiction. Similarly, if different income tax rates apply to different categories of income (such as capital gains or income earned in particular industries), to the extent practicable a separate rate is applied to each individual category of interim period pre-tax income. While that degree of precision is desirable, it may not be achievable in all cases, and a weighted average of rates across jurisdictions or across categories of income is used if it is a reasonable approximation of the effect of using more specific rates.

Contractual or anticipated purchase price changes

Volume rebates or discounts and other contractual changes in the prices of raw materials, labour, or other purchased goods and services are anticipated in interim periods, by both the payer and the recipient, if it is probable that they have been earned or will take effect. Thus, contractual rebates and discounts are anticipated but discretionary rebates and discounts are not anticipated because the resulting asset or liability would not satisfy the conditions in the *Framework* that an asset must be a resource controlled by the entity as a result of a past event and that a liability must be a present obligation whose settlement is expected to result in an outflow of resources.

Depreciation and amortisation

Depreciation and amortisation for an interim period is based only on assets owned during that interim period. It does not take into account asset acquisitions or dispositions planned for later in the financial year.

Inventories

Inventories are measured for interim financial reporting by the same principles as at financial year-end. Ind AS 2, *Inventories* establishes standards for recognising and measuring inventories. Inventories pose particular problems at the end of any financial reporting period because of the need to determine inventory quantities, costs, and net realisable values. Nonetheless, the same measurement principles are applied for interim inventories. To save cost and time, entities often use estimates to measure inventories at interim dates to a greater extent than at the end of annual reporting periods. Following are examples of how to apply the net realisable value test at an interim date and how to treat manufacturing variances at interim dates:

- **Net realisable value of inventories**

  The net realisable value of inventories is determined by reference to selling prices and related costs to complete and dispose at interim dates. An entity will reverse a write-down to net realisable value in a subsequent interim period only if it would be appropriate to do so at the end of the financial year.

- **Interim period manufacturing cost variances**

  Price, efficiency, spending, and volume variances of a manufacturing entity are recognised in income at interim reporting dates to the same extent that those variances are recognised in income at financial year-end. Deferral of variances that are expected to be absorbed by year-end is not appropriate because it could result in reporting inventory at the interim date at more or less than its portion of the actual cost of manufacture.

Foreign currency translation gains and losses

Foreign currency translation gains and losses are measured for interim financial reporting by the same principles as at financial year-end.

Ind AS 21, *The Effects of Changes in Foreign Exchange Rates* specifies how to translate the financial statements for foreign operations into the presentation currency, including guidelines for using average or closing foreign exchange rates and guidelines for recognising the resulting adjustments in profit or loss or in other comprehensive income. Consistently with Ind AS 21, the actual average and closing rates for the interim period are used. Entities do not anticipate some future changes in foreign exchange rates in the remainder of the current financial year in translating foreign operations at an interim date.

If Ind AS 21 requires translation adjustments to be recognised as income or expense in the period in which they arise, that principle is applied during each interim period. Entities do not defer some foreign currency translation adjustments at an interim date if the adjustment is expected to reverse before the end of the financial year.

4	Use of estimates	1. To ensure that the resulting information is reliable and that all material financial information that is relevant to an understanding of the financial position or performance of the entity is appropriately disclosed. **2.** The preparation of interim financial reports requires a greater use of estimation methods than annual financial reports.

Examples:

Inventories

Full stock-taking and valuation procedures may not be required for inventories at interim dates, although it may be done at financial year-end. It may be sufficient to make estimates at interim dates based on sales margins.

Provisions

Determination of the appropriate amount of a provision (such as a provision for warranties, environmental costs, and site restoration costs) may be complex and often costly and time-consuming. Entities sometimes engage outside experts to assist in the annual calculations. Making similar estimates at interim dates often entails updating of the prior annual provision rather than the engaging of outside experts to do a new calculation.

Pensions

Ind AS 19, *Employee Benefits* requires that an entity determine the present value of defined benefit obligations and the market value of plan assets at the end of each reporting period and encourages an entity to involve a professionally qualified actuary in measurement of the obligations. For interim reporting purposes, reliable measurement is often obtainable by extrapolation of the latest actuarial valuation.

Contingencies

The measurement of contingencies may involve the opinions of legal experts or other advisers. Formal reports from independent experts are sometimes obtained with respect to contingencies.

Such opinions about litigation, claims, assessments, and other contingencies and uncertainties may or may not also be needed at interim dates.

Inter-company reconciliations

Some intercompany balances that are reconciled on a detailed level in preparing consolidated financial statements at financial year-end might be reconciled at a less detailed level in preparing consolidated financial statements at an interim date.

Illustration 1

Company A has reported ₹ 60,000 as pre tax profit in first quarter and expects a loss of ₹ 15,000 each in the subsequent quarters. It has a corporate tax slab of 20 percent on the first ₹ 20,000 of annual earnings and 40 per cent on all additional earnings. Calculate the amount of tax to be shown in each quarter.

Solution

Amount of income tax expense reported in each quarter would be as below:

Expected total Income = ₹ 15,000 [60,000- (15,000 x 3)]

Expected tax as per slabs = 15,000 x 20% = ₹ 3,000

Average Annual Income tax rate = 3,000/15,000 = 20%

	Q1	Q2	Q3	Q4
Profit before tax	60,000	(15,000)	(15,000)	(15,000)
Tax expense	12,000	(3,000)	(3,000)	(3,000)

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2.8 RESTATEMENT OF PREVIOUSLY REPORTED INTERIM PERIODS

A change in accounting policy, other than one for which the transition is specified by a new Ind AS, shall be reflected by:

(a) restating the financial statements of prior interim periods of the current financial year and the comparable interim periods of any prior financial years that will be restated in the annual financial statements in accordance with Ind AS 8; or

(b) when it is impracticable to determine the cumulative effect at the beginning of the financial year of applying a new accounting policy to all prior periods, adjusting the financial statements of prior interim periods of the current financial year, and comparable interim periods of prior financial years to apply the new accounting policy prospectively from the earliest date practicable.

Under Ind AS 8, a change in accounting policy is reflected by retrospective application, with restatement of prior period financial data as far back as is practicable. However, if the cumulative amount of the adjustment relating to prior financial years is impracticable to determine, then under Ind AS 8 the new policy is applied prospectively from the earliest date practicable.

The effect of this along with respect to interim periods shall be that within the current financial year any change in accounting policy is applied either retrospectively or, if that is not practicable, prospectively, from no later than the beginning of the financial year.

2.9 INTERIM FINANCIAL REPORTING AND IMPAIRMENT

An entity is required to assess goodwill for impairment at the end of each reporting period, and, if required, to recognise an impairment loss at that date in accordance with Ind AS 36. However, at the end of a subsequent reporting period, conditions may have so changed that the impairment loss would have been reduced or avoided had the impairment assessment been made only at that date.

Accordingly, an entity shall not reverse an impairment loss recognised in a previous interim period in respect of goodwill.

Illustration 2

ABC Limited manufactures automobile parts. ABC Limited has shown a net profit of ₹ 20,00,000 for the third quarter of 20X1.

Following adjustments are made while computing the net profit:

(i) Bad debts of ₹1,00,000 incurred during the quarter. 50% of the bad debts have been deferred to the next quarter.

(ii) Additional depreciation of ₹ 4,50,000 resulting from the change in the method of depreciation.

(iii) ₹ 5,00,000 expenditure on account of administrative expenses pertaining to the third quarter is deferred on the argument that the fourth quarter will have more sales; therefore fourth quarter should be debited by higher expenditure. The expenditures are uniform throughout all quarters.

Ascertain the correct net profit to be shown in the Interim Financial Report of third quarter to be presented to the Board of Directors.

Solution

In the instant case, the quarterly net profit has not been correctly stated. As per Ind AS 34, *Interim Financial Reporting*, the quarterly net profit should be adjusted and restated as follows:

(i) The treatment of bad debts is not correct as the expenses incurred during an interim reporting period should be recognised in the same period. Accordingly, ₹ 50,000 should be deducted from ₹ 20,00,000.

(ii) Recognising additional depreciation of ₹ 4,50,000 in the same quarter is correct and is in tune with Ind AS 34.

(iii) As per Ind AS 34 the income and expense should be recognised when they are earned and incurred respectively. As per para 39 of Ind AS 34, the costs should be anticipated or deferred only when:

(i) it is appropriate to anticipate or defer that type of cost at the end of the financial year, and

(ii) costs are incurred unevenly during the financial year of an enterprise.

Therefore, the treatment done relating to deferment of ₹ 5,00,000 is not correct as expenditures are uniform throughout all quarters.

Thus considering the above, the correct net profits to be shown in Interim Financial Report of the third quarter shall be ₹ 14,50,000 (₹ 20,00,000 - ₹ 5,00,000 - ₹ 50,000).

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2.10 SIGNIFICANT DIFFERENCES IN IND AS 34 VIS-À-VIS AS 25

S. No.	Particular	Ind AS 34	AS 25
1.	*Scope*	Ind AS 34 applies only if an entity is required or elects to prepare and present an interim financial report in accordance with Indian Accounting Standards. Consequently, it is specifically stated in Ind AS 34 that the fact that an entity may not have provided interim financial reports during a particular financial year or may have provided interim financial reports that do not comply with Ind AS 34 does not prevent the entity's annual financial statements from conforming to Ind AS if they otherwise do so.	As per AS 25, if an entity is required or elects to prepare and present an interim financial report, it should comply with that standard.
2.	*Complete set of Financial Statements*	In Ind AS 34, the term 'complete set of financial statements' appearing in the definition of interim financial report has been	Definition of 'complete set of financial statements' does not include such previous balance sheet.

		expanded. It includes balance sheet as at the beginning of the preceding period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements and comparative information in respect of the preceding period.	
3.	*Contents of Interim Report*	Ind AS 34 requires a condensed statement of changes in equity.	As per AS 25, the contents of an interim financial report include, at a minimum, a condensed balance sheet, a condensed statement of profit and loss, a condensed cash flow statement and selected explanatory notes.
4.	*Reversal of Impairment Loss*	Ind AS 34 prohibits reversal of impairment loss recognised in a previous interim period in respect of goodwill or an investment in either an equity instrument or a financial asset carried at cost.	There is no such specific prohibition in the AS 25.
5.	*Inclusion of the Parent's Separate Statements and the Consolidated Financial Statements in the Entity's Interim Report*	Ind AS 34 states that it neither requires nor prohibits the inclusion of the parent's separate statements in the entity's interim report prepared on a consolidated basis.	Under AS 25, if an entity's annual financial report included the consolidated financial statements in addition to the separate financial statements, the interim financial report should include both the consolidated financial statements and separate financial statements, complete or condensed.
6.	*Accounting Policies*	Ind AS 34 additionally requires the information in respect of methods of computation followed.	AS 25 requires the Notes to interim financial statements, (if material and not disclosed

			elsewhere in the interim financial report), to contain a statement that the same accounting policies are followed in the interim financial statements as those followed in the most recent annual financial statements or, in case of change in those policies, a description of the nature and effect of the change.
7.	*Dividends*	Ind AS 34 requires furnishing of information, in interim financial report, on dividends paid, aggregate or per share separately for equity and other shares.	AS 25 requires furnishing information, in interim financial report, of dividends, aggregate or per share (in absolute or percentage terms), for equity and other shares.
8.	*Contingent Liabilities and Contingent Assets*	Ind AS 34 requires furnishing of information on both contingent liabilities and contingent assets, if they are significant.	AS 25 requires furnishing of information on contingent liabilities only.
9.	*Extraordinary Items*	Reference to extraordinary items (in the context of materiality) is deleted in Ind AS 34 in line with the Ind AS 1	AS 25 has reference of extraordinary items.
10.	*Interim Financial Statements prepared on Complete Basis*	Ind AS 34 requires that, where an interim financial report has been prepared in accordance with the requirements of Ind AS 34, that fact should be disclosed. Further, an interim financial report should not be described as complying with Ind AS unless it complies with all of the requirements of Ind AS. (The latter statement is applicable when interim financial statements are prepared on complete basis instead of 'condensed basis').	AS 25 does not contain these requirements.
11.	*Change in*	Ind AS 34 additionally requires	Under AS 25, a change in

	Accounting Policy	restatement of the comparable interim periods of prior financial years that will be restated in annual financial statements in accordance with Ind AS 8, subject to specific provisions when such restatement is impracticable.	accounting policy, other than the one for which the transitional provisions are specified by a new Standard, should be reflected by restating the financial statements of prior interim periods of the current financial year.
12.	*Impact of Convergence*	Convergence of all other standards with IFRS also has impact on interim financial reporting. For example, treatment of constructive obligation in Ind AS 37, etc. will have impact in interim financial reporting which could be different in the context of relevant existing standards. There are other consequential impacts also. Since the concept of extraordinary items is no longer valid in the context of Ind AS 1 the question of EPS with and without extraordinary items does not arise in the context of Ind AS 33. This changed requirement of Ind AS 33 is equally applicable to interim financial reporting under Ind AS 34.	AS 20 requires EPS with and without extraordinary items.

TEST YOUR KNOWLEDGE

Questions

1. Company A expects to earn ₹ 15,000 pre-tax profit each quarter and has a corporate tax slab of 20 percent on the first ₹ 20,000 of annual earnings and 40 per cent on all additional earnings. Actual earnings match expectations. Calculate the amount of income tax to be shown in each quarter.

2. Narayan Ltd. provides you the following information and asks you to calculate the tax expense for each quarter, assuming that there is no difference between the estimated taxable income and the estimated accounting income:

Estimated Gross Annual Income (inclusive of Estimated Capital Gains of ₹ 8,00,000)	33,00,000

Estimated Income of Quarter I is ₹ 7,00,000, Quarter II is ₹ 8,00,000, Quarter III (including Estimated Capital Gains of ₹ 8,00,000) is ₹ 12,00,000 and Quarter IV is ₹ 6,00,000.

Tax Rates:	On Capital Gains		12%
	On Other Income:	First ₹ 5,00,000	30%
		Balance Income	40%

3. An entity reports quarterly, earns Rs. 1,50,000 pre-tax profit in the first quarter but expects to incur losses of Rs. 50,000 in each of the three remaining quarters. The entity operates in a jurisdiction in which its estimated average annual income tax rate is 30%.

   The management believes that since the entity has zero income for the year, its income-tax expense for the year will be zero. State whether the management's views are correct or not? If not, then calculate the tax expense for each quarter as well as for the year as per Ind AS 34.

Answers

1. The following table shows the amount of income tax expense that is reported in each quarter:

Expected Total Income = 15,000 x 4 = ₹ 60,000				
Expected Tax as per slabs = 20,000 x 20% + 40,000 x 40% = ₹ 20,000				
Average Annual Income tax rate = 20,000/60,000 x 100 = 33.33%				
				Amt (₹)
	Q1	Q2	Q3	Q4
Profit before tax	15,000	15,000	15,000	15,000
Tax expense	5,000	5,000	5,000	5,000

2. As per para 29 of AS 25 'Interim Financial Reporting', income tax expense is recognised in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year.

   If different income tax rates apply to different categories of income (such as capital gains or income earned in particular industries) to the extent practicable, a separate rate is applied to each individual category of interim period pre-tax income.

	₹
Estimated annual income exclusive of estimated capital gain (33,00,000 – 8,00,000) (A)	25,00,000
Tax expense on other income:	
30% on ₹ 5,00,000	1,50,000
40% on remaining ₹ 20,00,000	8,00,000
(B)	9,50,000
Weighted average annual income tax rate = $\frac{B}{A} = \frac{9,50,000}{25,00,000} = 38\%$	

Tax expense to be recognised in each of the quarterly reports

		₹
Quarter I - ₹ 7,00,000 x 38%		2,66,000
Quarter II - ₹ 8,00,000 x 38%		3,04,000
Quarter III - ₹ (12,00,000 - 8,00,000) x 38%	1,52,000	
₹ 8,00,000 x 12%	96,000	2,48,000
Quarter IV - ₹ 6,00,000 x 38%		2,28,000
		10,46,000

3. As illustrated in para 30 (c) of Ind AS 34 'Interim financial reporting', income tax expense is **recognised in each interim period** based on the best estimate of the weighted average annual income tax rate expected for the full financial year.

   Accordingly, the management's contention that since the net income for the year will be zero no income tax expense shall be charged quarterly in the interim financial report, is not correct. The following table shows the correct income tax expense to be reported each quarter in accordance with Ind AS 34:

Period	**Pre-tax earnings (in ₹)**	**Effective tax rate**	**Tax expense (in ₹)**
First Quarter	1,50,000	30%	45,000
Second Quarter	(50,000)	30%	(15,000)
Third Quarter	(50,000)	30%	(15,000)
Fourth Quarter	(50,000)	30%	(15,000)
Annual	**0**		**0**

UNIT 3: INDIAN ACCOUNTING STANDARD 7: STATEMENT OF CASH FLOWS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand the meaning of cash flow statement
- Describe the objective and scope of issuance of Ind AS 7
- Define the relevant terms used in the Ind AS
- Classify the types of cash flows into operating, investing and financing activities
- Distinguish between direct and indirect method of presentation of cash flows under the operating activity
- Identify the provision applicable to various peculiar situations of cash flows
- Disclose the necessary information as required in the standard
- Differentiate between Ind AS 7 and AS 3.

UNIT OVERVIEW

Ind AS 7	• Objectives • Scope • Benefits • Definitions
Presentation of Statement of Cash Flows	• Operating Cash Flows • Investing Cash Flows • Financing Cash Flows
Method of Presentation	• Direct Method • Indirect Method
Peculiar Cases of Cash flows	• Reporting on a net basis • Foreign Currency Transactions • Interest and Dividend • Taxes on Income • Investments in Subsidiaries, associates and Joint ventures • Changes in ownerships Interests in subsidiaries and other businesses • Non Cash Transactions
Discosure	• Components of cash and cash equivalents • Other Disclosures

3.1 INTRODUCTION

The balance sheet is a snapshot of entity's financial resources and obligations at a particular point of time and the statement of profit and loss reflects the financial performance for the period. These two components of financial statements are based on accrual basis of accounting. The statement of cash flows includes only inflows and outflows of cash and cash equivalents; it excludes transactions that do not affect cash receipts and payments.

The information on cash flows is useful in assessing sources of generating and deploying cash and cash equivalents during the reporting period. The statement of cash flows can be used for comparison with earlier reporting periods of the same entity as well as comparison with other entities for the same reporting period.

Ind AS 7, Statement of Cash Flows, prescribes principles and guidance on preparation and presentation of cash flows of an entity from operating activities, investing activities and financing activities for a reporting period.

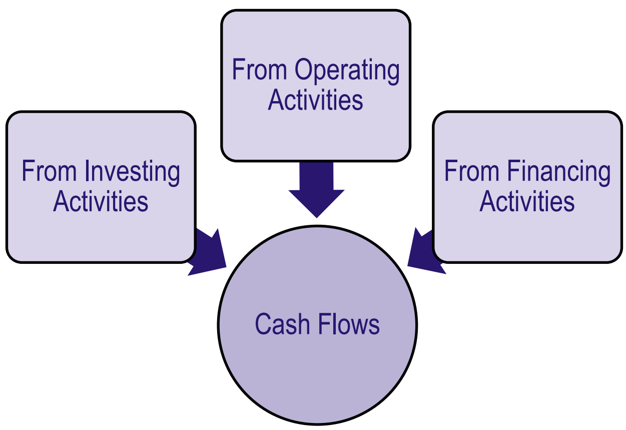
3.2 MEANING OF STATEMENT OF CASH FLOWS

Cash flow statement, in simple words is a statement, which provides the details about how the cash is generated by an entity during the particular reporting period and how it is applied. While doing so, it takes into consideration the opening balances of cash and cash equivalents, adds the cash generated, deducts the cash payments and reconciles it with closing balances of cash and cash equivalents. The cash flows are classified into following three main categories:

(a) Cash flows from Operating Activities

(b) Cash flows from Investing Activities

(c) Cash flows from Financing Activities



The simplified example of cash flow statement, for understanding purpose is given below

Particulars	Amount (₹)
Cash flow from Operations Activities	10,000
Cash flow from Investing Activities	(2,000)
Cash flow from Financing Activities	(4,000)
Net Cash Generated during the year	4,000
Add: Cash and Cash Equivalents at the beginning of the year	13,000
Cash and Cash Equivalents at the end of the year (which will also tally with the cash and cash equivalents given in the balance sheet)	17,000

Thus, one can see that at the beginning of the year, the **opening balance** of cash and cash equivalent was ₹ 13,000. During the year, the business **generated (inflow)** cash from its main operations ₹ 10,000. Thus, the entity had ₹ 23,000 at its disposal. Out of it, the entity has **used (outflow)** ₹ 2,000 for additional investments and ₹ 4,000 for financing activities. Therefore, at the end of the year, the entity is left with the balance of ₹ 17,000.

3.3 OBJECTIVE

Ind AS 7, has specified the following objectives of Statement of Cash Flows:

3.3.1 To provide information about historical changes in cash and cash equivalents

Cash flow statement aims at providing the information about how the cash has been generated during the year and for what purposes has it been utilised. The information will be provided for current year and immediate previous year.

3.3.2 To assess the ability to generate cash and cash equivalents

Cash flow statement is intended to provide the stakeholders about the efficiency of the company in generating cash and cash equivalents. Some companies may look profitable as per profit and loss account but whether they have enough cash for payment of their debts and creditors has to be assessed by using cash flow statement.

3.3.3 To understand the timing and certainty of their generation

The historical analysis of statement of cash flow can set a trend regarding the years in which company could generate fair amount of cash flows and the probability of generating it.

3.4 BENEFITS OF CASH FLOW INFORMATION

3.4.1 Provides information enabling evaluation of changes in net assets and financial structure (Liquidity and solvency)

Cash flow statement reconciles the opening balances of cash and cash equivalents with the closing balances of cash and cash equivalents, giving the reasons for the changes happened during the year. Thus it provides a clear picture of cash inflows and out flows that have taken place during the reporting period.

3.4.2 Assesses the ability to manage the cash

The stakeholders get an idea about what is the source of generation of cash and how it is used for. The information gives a fair idea about the efficiency and ability of the company to generate cash.

For example, suppose there is negative cash flow from operations. It denotes that company is unable to generate cash from its main business activity, which is not a favourable situation.

Cash flow statements can also throw light on whether company could generate sufficient cash or not.

For example, company wants to expand its production capacity. The cash flow statement can indicate whether company could generate the required cash from their operations, or whether company has generated the funds from share capital or whether company has taken a loan for the same.

3.4.3 Assess and compare the present value of future cash flows

The past trends of cash flows will help the company to predict about future cash flows. Such information is useful while evaluating the projects on capital budgeting or valuation of shares. Thus it forms the base for future projects and can be discounted using discounting techniques.

3.4.4 Compares the efficiency of different entities

Accounting profits of various entities may have different assumptions, policies and definitions. However, cash flows will be calculated by using the same technique and finally all differing assumptions across the companies will melt down and entity will reach to a common comparable base of cash and cash equivalents.

3.5 SCOPE

An entity shall prepare a statement of cash flows in accordance with the requirements of this Standard and shall present it as an integral part of its financial statements for each period for which financial statements are presented.

The Standard requires all entities to present a statement of cash flows.

Every organisation, whether it is small or big in size, whether it's a manufacturing organisation or trading concern or service organisation, needs cash for running its business. The cash is also needed for future investments. Cash would be needed for payment of dividends, repayment of loans as well. Thus any organisation is required to generate the cash and utilises cash continuously.

Banks and Financial institutions are also not an exception to the same. Even if they deal with financial products, accept deposits and give loans day in and day out, they need to generate the cash profit for their own organisation. They need to make investments in terms of new branches, set ups etc. Thus statement of cash flow is equally important for Banking and Financial Institutions as well.

3.6 DEFINITIONS

The following terms are used in this Standard with the meanings specified:

1. ***Cash*** comprises cash on hand and demand deposits.
2. ***Cash equivalents*** are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.
3. ***Cash flows*** are inflows and outflows of cash and cash equivalents.
4. ***Operating activities*** are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.
5. ***Investing activities*** are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.
6. ***Financing activities*** are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

3.7 CASH AND CASH EQUIVALENTS

Cash Equivalent means investments which can be realised easily in cash in a short period from the date of investing the same.

1. **Purpose:** Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes.
2. **Liquidity and Risk :** For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the **date of acquisition**.

3. **Equity investments** are excluded from cash equivalents unless they are, in substance, cash equivalents.

4. **Bank borrowings** are generally considered to be financing activities. However, the bank overdrafts are an integral part of an entity's cash management, bank overdrafts are included as a component of cash and cash equivalents. A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn. Further, it is important to note that the bank overdraft due to issuance of cheques at the end of the cut-off period is not a part of cash and cash equivalent.

5. **Cash Management:** Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an entity rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents.

Illustration 1

Company has provided the following information regarding the various assets held by company on 31st March 20X1. Find out, which of the following items will be part of cash and cash equivalents for the purpose of preparation of cash flow statement as per the guidance provided in Ind AS 7:

Sr. No.	*Name of the Security*	*Additional Information*
1.	*Fixed deposit with SBI*	*12%, 3 years maturity on 1st Jan 20X4*
2.	*Fixed deposit with HDFC*	*10%, original term was for 2 years, but due for maturity on 30.06.20X1*
3.	*Redeemable Preference shares in ABC ltd*	*Acquired on 29th January 20X1 and the redemption is due on 30th April 20X1*
4.	*Cash balances at various banks*	*All branches of all banks in India*
5.	*Cash balances at various banks*	*All international branches of Indian banks*
6.	*Cash balances at various banks*	*Branches of foreign banks outside India*
7.	*Bank overdraft of SBI Fort branch*	*Temporary overdraft, which is payable on demand*
8.	*Treasury Bills*	*90 days maturity*

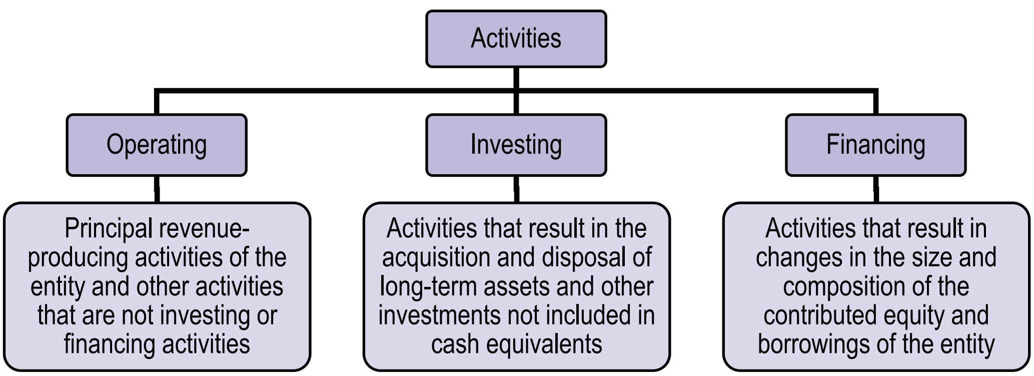
Solution

Sr. No.	Name of the Security	Decision
1.	Fixed deposit with SBI	Not to be considered – long term
2.	Fixed deposit with HDFC	Exclude as original maturity is not less than 90 days from the date of acquisition
3.	Redeemable Preference shares in ABC Ltd.	Include as due within 90 days from the date of acquisition
4.	Cash balances at various banks	Include
5.	Cash balances at various banks	Include
6.	Cash balances at various banks	Include
7.	Bank overdraft of SBI Fort branch	Include
8.	Treasury Bills	Include

*****

3.8 PRESENTATION OF STATEMENT OF CASH FLOWS

The statement of cash flows shall report cash flows during the period classified by operating, investing and financing activities.



3.8.1 Operating Activities

- Cash flows from operating activities are primarily derived from the principal revenue producing activities of the entity ie from operations of the business. Therefore, they are, in general, the result of the transactions and events that enter into the determination of profit or loss.

Examples of cash flows from operating activities are:

Operating Cash Inflows	Operating Cash Outflows
Cash receipts from the sale of goods and the rendering of services	Cash payments to suppliers for goods and services
Cash receipts from royalties, fee, commission and other revenue	Cash payments to and on behalf of employees
Cash receipts and cash payments of an insurance entity for premiums and claims, annuities and other policy benefits	Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities
Cash receipts and payments from contracts held for dealing or trading purposes	

Illustration 2

From the following transactions, identify which transactions will be qualified for the calculation of operating cash flows, if company is into the business of trading of mobile phones

Sr. No.	*Nature of Transaction*
1	*Receipt from sale of mobile phones*
2	*Purchases of mobile phones from various companies*
3	*Employees expenses paid*
4	*Advertisement expenses paid*
5	*Credit sales of mobile*
6	*Misc. charges received from customers for repairs of mobiles*
7	*Loss due to decrease in market value of the closing stock of old mobile phones*
8	*Payment to suppliers of mobile phones*
9	*Depreciation on furniture of sales showrooms*
10	*Interest paid on cash credit facility of the bank*
11	*Profit on sale of old computers and printers, in exchange of new laptop and printer*
12	*Advance received from customers*
13	*Sales Tax and excise duty paid*

Solution

Sr. No.	Nature of Transaction	Included / Excluded with reason
1	Receipt from sale of mobile phones	Include – main revenue generating activity
2	Purchases of mobile phones from various companies	Include – expenses related to main operations of business
3	Employees expenses paid	Include – expenses related to main operations of business
4	Advertisement expenses paid	Include – expenses related to main operations of business
5	Credit sales of mobile	Do not include – Credit transaction will not be included in cash flow (receipts from customers will be included)
6	Misc. charges received from customers for repairs of mobiles	Include – supplementary revenue generating activity
7	Loss due to decrease in market value of the closing stock of old mobile phones	Do not include - Non cash transaction
8	Payment to suppliers of mobile phones	Include – cash outflow related to main operations of business
9	Depreciation on furniture of sales showrooms	Do not include – non cash item
10	Interest paid on cash credit facility of the bank	Do not include – cost of finance
11	Profit on sale of old computers and printers, in exchange of new laptop and printer	Do not include – non cash item
12	Advance received from customers	Include – Related to operations of business
13	Sales tax and excise duty paid	Include – related to operations of business

*****

- The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the entity have generated sufficient cash flows or not. If the cash flow from operations is positive, it will be treated as positive indicator whereas negative cash flow from operations will denote that company's ability to generate the revenue from its main operations is very weak. The companies in the initial stage of their business or the companies which are facing economic problems will generally have the negative cash flow from operations.

- Cash flow from operations are used to maintain the operating capability of the entity, pay dividends and make new investments without recourse to external sources of financing. Therefore, it is necessary to assess how much cash is generated by the business from operations? Are they sufficient to take care of their future investment plans? Can loans be repaid in time without default from such cash flows? Is there sufficient amount for payment of preference dividend? Is anything left for equity shareholders after making all these payments? Answers to all these questions will depend on whether the entity has generated enough cash or not.

3.8.1.1 Certain Specific Issues

1. **Profit / Loss on Sale of Assets :** Some transactions, such as the sale of an item of plant, may give rise to a gain or loss that is included in recognised profit or loss. The cash flows relating to such transactions are cash flows from investing activities.

2. **Properties built for let out :** Cash payments to manufacture or acquire assets held for rental to others and subsequently held for sale are cash flows from operating activities. The cash receipts from rents and subsequent sales of such assets are also cash flows from operating activities.

3.8.2 Investing Activities

Investment means sacrifice of current resource in a view to get more returns in future. All entities need some amount of investment for their future survival.

Ind AS 7 states that investing activities represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Only expenditures that result in a recognized asset in the balance sheet are eligible for classification as investing activities.

Examples of cash flows arising from investing activities are:

Cash Inflow from Investing Activities	Cash Outflow from Investing Activities
Cash receipts from sales of property, plant and equipment, intangibles and other long-term assets	Cash payments to acquire property, plant and equipment, intangibles and other long-term assets. These payments include those relating to capitalised development costs and self-constructed property, plant and equipment
Cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for dealing or trading purposes)	Cash payments to acquire equity or debt instruments of other entities and interests in joint ventures (other than payments for those instruments considered to be cash equivalents or those held for dealing or trading purposes);

Cash receipts from the repayment of advances and loans made to other parties (other than advances and loans of a financial institution)	Cash advances and loans made to other parties (other than advances and loans made by a financial institution)
Cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities	Cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities

When a contract is accounted for as a hedge of an identifiable position the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

Illustration 3

From the following transactions taken from a private sector bank operating in India, identify which transactions will be classified as operating and which would be classified as Investing activity.

S. No.	*Nature of transaction paid*
1	*Interest received on loans*
2	*Interest paid on Deposits*
3	*Deposits accepted*
4	*Loans given to customers*
5	*Loans repaid by the customers*
6	*Deposits repaid*
7	*Commission received*
8	*Lease rentals paid for various branches*
9	*Service tax paid*
10	*Furniture purchased for new branches*
11	*Implementation of upgraded banking software*
12	*Purchase of shares in 100% subsidiary for opening a branch in Abu Dhabi*
13	*New cars purchased from Honda dealer, in exchange of old cars*
14	*Provident fund paid for the employees*
15	*Issued employee stock options*

Solution

Sr. No.	Nature of transaction paid	Operating / Investing / Not to be considered
1	Interest received on loans	Operating – Main revenue generating activity

2	Interest paid on Deposits	Operating – Main expenses of operations
3	Deposits accepted	Operating – in case of financial institutes
4	Loans given to customers	Operating – in case of financial institutes
5	Loans repaid by the customers	Operating – in case of financial institutes
6	Deposits repaid	Operating – in case of financial institutes
7	Commission received	Operating – Main revenue generating activity
8	Lease rentals paid for various branches	Operating – Main expenses of operations
9	Service tax paid	Operating – Main expenses of operations
10	Furniture for new branches	Investing – Assets purchased
11	Implementation of upgraded banking software	Investing – Purchased for long term purpose
12	Purchase of shares in 100% subsidiary for opening a branch in Abu Dhabi	Investing – strategic investment
13	New cars purchased from Honda dealer, in exchange of old cars	Investing
14	Provident fund paid for the employees	Operating
15	Issued employee stock options	Not to be considered. No cash flow

*****

3.8.3 Financing Activities

During the life time of the entity, it needs money for long term investments as well as for working capital purpose. Company can raise the capital by way of equity or loans. Thus the cash flows related to raising of funds and redemption of funds will be covered under Cash flows from financing activities. The cost of capital is also generally covered under the Financing Activity.

Ind AS 7 states that the cash flows from Financing activity are useful in predicting claims on future cash flows by providers of capital to the entity.

Cash Inflows from Financing Activity	Cash Outflows from Financing Activity
Cash proceeds from issuing shares or other equity instruments;	Cash payments to owners to acquire or redeem the entity's shares;

Cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other	Cash repayments of amounts borrowed; and
Short-term or long-term borrowings;	Cash payments by a lessee for the reduction of the outstanding liability relating to a lease.

Illustration 4

From the following transactions taken from a parent company having multiple businesses and multiple segments, identify which transactions will be classified as operating Investing and Financing:

Sr. No.	*Nature of transaction*
1	*Issued preference shares*
2	*Purchased the shares of 100% subsidiary company*
3	*Dividend received from shares of subsidiaries*
4	*Dividend received from other companies*
5	*Bonus shares issued*
6	*Purchased license for manufacturing of special drugs*
7	*Royalty received from the goods patented by the company*
8	*Rent received from the let out building (letting out is not main business)*
9	*Interest received from the advances given*
10	*Dividend paid*
11	*Interest paid on security deposits*
12	*Purchased goodwill*
13	*Acquired the assets of a company by issue of equity shares (not parting any cash)*
14	*Interim dividends paid*
15	*Dissolved the 100% subsidiary and received the amount in final settlement*

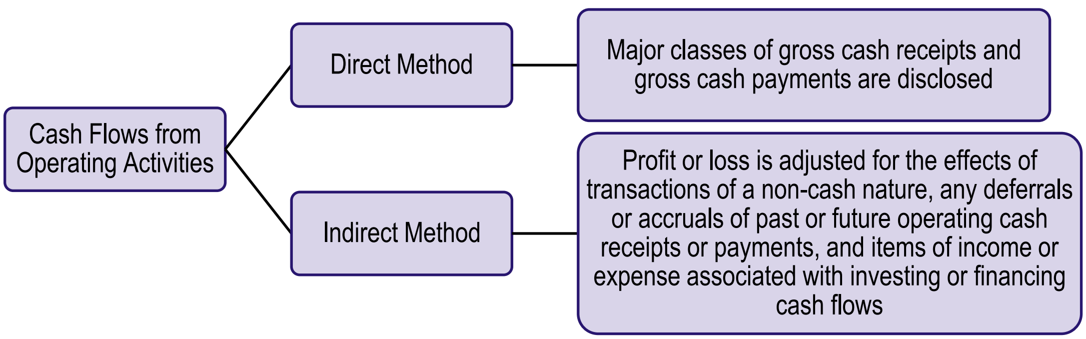
Solution

Sr. No.	Nature of transaction	Operating / Investing / Financing /Not to be considered
1	Issued preference shares	Financing
2	Purchased the shares of 100% subsidiary company	Investing
3	Dividend received from shares of subsidiaries	Investing
4	Dividend received from other companies	Investing
5	Bonus shares issued	No cash flow

6	Purchased license for manufacturing of special drugs	Investing
7	Royalty received from the goods patented by the company	Operating
8	Rent received from the let out building (letting out is not main business)	Investing
9	Interest received from the advances given	Operating
10	Dividend paid	Financing
11	Interest paid on security deposits	Financing
12	Purchased goodwill	Investing
13	Acquired the assets of a company by issue of equity shares (not parting any cash)	Not to be considered
14	Interim dividends paid	Financing
15	Dissolved the 100% subsidiary and received the amount in final settlement	Investing

*****

3.9 REPORTING CASH FLOWS FROM OPERATING ACTIVITIES



- An entity shall report cash flows from operating activities using either:

  (a) the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or

  (b) the indirect method, whereby profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

- Entities are encouraged to report cash flows from operating activities using the direct method. The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method. Under the direct method, information about major classes of gross cash receipts and gross cash payments may be obtained either:

(a) from the accounting records of the entity; or

(b) by adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial institution) and other items in the statement of profit and loss for:

   (i) changes during the period in inventories and operating receivables and payables;

   (ii) other non-cash items; and

   (iii) other items for which the cash effects are investing or financing cash flows.

Analysis

Direct method starts with cash revenue/income/ receipts of the company. All the cash expenses will be deducted from such cash revenue. The cash profit will be adjusted for the cash flows arising from investing and financing activities. Non-cash expenses/losses/gains will not be considered. The payments to suppliers and receipts from customers are also taken into consideration. The resultant figure would cash flow from operating activity. The exercise would be similar to converting the income and expenditure account (accrual system) into receipt and payment (cash system), with the difference effects on investments and liabilities will not be considered. Thus if we consider the vertical operating statement, direct method will have (TOP down) approach of presentation.

- Under the indirect method, the net cash flow from operating activities is determined by adjusting profit or loss for the effects of:

(a) changes during the period in inventories and operating receivables and payables;

(b) non-cash items such as depreciation, provisions, deferred taxes, unrealised foreign currency gains and losses, and undistributed profits of associates; and

(c) all other items for which the cash effects are investing or financing cash flows.

Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing the revenues and expenses disclosed in the statement of profit and loss and the changes during the period in inventories and operating receivables and payables.

Analysis

Indirect method is reverse of direct method. It starts with the accounting profit after tax as given in profit and loss accounts. Thereafter, the profit will be adjusted for non-cash items, losses and gains on investing and financing activities, interest and dividends, collection and payments to debtors/creditors etc. Accordingly, the cash from operating activity will derived. Thus indirect method will have (Bottom up) approach.

Note: Under both the methods the amount of cash flow from Operating activities need to be necessarily same. It's only the approach for presentation which differs.

Illustration 5

Find out the cash from operations by direct method and indirect method from the following information:

Operating statement of ABC Ltd. for the year ended 31.3.2017

Particulars	₹
Sales	5,00,000.00
Less: Cost of goods sold	3,50,000.00
Administration & Selling Overheads	55,000.00
Depreciation	7,000.00
Interest Paid	3,000.00
Loss on sale of asset	2,000.00
Profit before tax	83,000.00
Tax	(30,000.00)
Profit After tax	**53,000.00**

Balance Sheet as on 31st March

	2017	2016
Assets		
Non-current Assets		
Property, Plant and Equipment	75,000.00	65,000.00
Investment	12,000.00	10,000.00
Current Assets		
Inventories	12,000.00	13,000.00
Trade receivables	10,000.00	7,000.00
Cash and cash equivalents	6,000.00	5,000.00
Total	**1,15,000.00**	**1,00,000.00**
Equity and Liabilities		
Shareholders' Funds	60,000.00	50,000.00
Non-current Liabilities	25,000.00	30,000.00

Current Liabilities		
Trade Payables	*12,000.00*	*8,000.00*
Payables for Expenses	*10,000.00*	*7,000.00*
Provisions	*8,000.00*	*5,000.00*
Total	***1,15,000.00***	***1,00,000.00***

Solution

1. Cash flow from Operations by Direct Method

Particulars	₹	See Note
Cash Sales	4,97,000.00	1
Less: Cash Purchases	3,45,000.00	2
Overheads	52,000.00	3
Interest	-	Financing
Depreciation	-	Non cash item
Loss	-	Non cash item
Cash profit	**100,000.00**	
Less: Tax	(30,000.00)	
Cash profit after tax	**70,000.00**	

Note No 1 - Cash Receipts from Sales and Trade receivables

Particulars	₹	
Sales	500,000.00	
Add : Opening Trade receivables	7,000.00	
Less : Closing Trade receivables	(10,000.00)	
Cash Receipts	**497,000.00**	

Note No 2 :- Payment to Trade Payables for Purchases

Particulars	₹	
Cost of goods sold	350,000.00	
Closing inventories	12,000.00	
Less: Opening inventories	(13,000.00)	
Purchases	349,000.00	
Add: Opening Trade Payables	8,000.00	
Less: Closing Trade Payables	(12,000.00)	

Payment to creditors	**345,000.00**	
Note No 3 :- Payment to payables for Expenses		
Particulars	**₹**	
Overheads	55,000.00	
Add: Opening payables	7,000.00	
Less: Closing payables	(10,000.00)	
Payment for Overheads	**52,000.00**	

2. Cash flow from Operations by Indirect Method

Indirect Method	**₹**
Profit After Tax	53,000.00
Add/(Less) : Depreciation	7,000.00
Loss on Asset	2,000.00
Interest paid	3,000.00
Decrease in Inventory	1,000.00
Increase in Trade Receivables	(3,000.00)
Increase in Trade Payables	4,000.00
Increase in Payables for expenses	3,000.00
Total	**70,000.00**

Note: Cash flow derived from operations ₹ 70,000 is same both from Direct Method and Indirect Method.

*****

3.10 REPORTING CASH FLOWS FROM INVESTING AND FINANCING ACTIVITIES

An entity is required to report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except to the extent that cash flows are permitted to be reported on a net basis.

3.11 REPORTING CASH FLOWS ON A NET BASIS

If nothing is specifically mentioned, then as per Ind AS 7, the cash flows will be presented on Gross Basis. Gross basis means the receipts would be shown separately and the payments will be shown separately.

Example:

If in the year 20X1-20X2, some land is purchased for ₹ 2.5 crores and another land is sold for ₹ 3.5 crores then while presenting the information, entity shall show separately outflow of ₹ 2.5 crores and inflow of ₹ 3.5 crores.

The above base has following exceptions

1. Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:

   (a) cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the entity;

   Examples of cash receipts and payments referred to in paragraph 22(a) are:

   - the acceptance and repayment of demand deposits of a bank;
   - funds held for customers by an investment entity; and
   - rents collected on behalf of, and paid over to, the owners of properties.

   (b) Cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.

   Examples of cash receipts and payments referred to in paragraph 22(b) are advances made for, and the repayment of:

   - principal amounts relating to credit card customers;
   - the purchase and sale of investments; and
   - other short-term borrowings, for example, those which have a maturity period of three months or less.

2. Cash flows arising from each of the following activities of a financial institution may be reported on a net basis:

   (a) cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date;

   (b) the placement of deposits with and withdrawal of deposits from other financial institutions; and

(c) cash advances and loans made to customers and the repayment of those advances and loans.

3.12 FOREIGN CURRENCY CASH FLOWS

- Cash flows arising from transactions in a foreign currency shall be recorded in an entity's functional currency by applying to the foreign currency amount the exchange rate between the functional currency and the foreign currency at the date of the cash flow.
- The cash flows of a foreign subsidiary shall be translated at the exchange rates between the functional currency and the foreign currency **at the dates of the cash flows**.

Example:

Suppose the money is received on account of exports on 15th January 2017 in US $. The company prepares the accounts in rupees. In such case the exchange rate between USD and Rupee as on 15th January 2017 need to be applied for conversion.

- Unrealised gains and losses arising from changes in foreign currency exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the statement of cash flows in order to reconcile cash and cash equivalents at the beginning and the end of the period. This amount is presented separately from cash flows from operating, investing and financing activities and includes the differences, if any, had those cash flows been reported at end of period exchange rates.

3.13 INTEREST AND DIVIDENDS

Cash flows from interest and dividends received and paid shall each be disclosed separately.

	Financing company	Other company
Interest paid	Cash flows arising from operating activities	Cash flows from financing activities
Interest and dividends received	Cash flows arising from operating activities	Cash flows from investing activities
Dividends paid	Cash flows from financing activities	Cash flows from financing activities

Illustration 6

A firm invests in a five-year bond of another company with a face value of ₹ 10,00,000 by paying ₹ 5,00,000. The effective rate is 15%. The firm recognises proportionate interest income in its income statement throughout the period of bond.

Based on the above information answer the following question:

a) How the interest income will be treated in cash flow statement during the period of bond?

b) On maturity, whether the receipt of ₹ 10,00,000 should be split between interest income and receipts from investment activity.

Solution

Interest Income will be treated as income over the period of bond in the income statement. However, there will be no cash flow in these years because no cash has been received. On maturity, receipt of ₹ 10,00,000 will be classified as investment activity with a bifurcation of interest income & money received on redemption of bond.

*****

3.14 TAXES ON INCOME

Cash flows arising from taxes on income shall be separately disclosed and shall be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

Taxes on income arise on transactions that give rise to cash flows that are classified as operating, investing or financing activities in a statement of cash flows. While tax expense may be readily identifiable with investing or financing activities, the related tax cash flows are often impracticable to identify and may arise in a different period from the cash flows of the underlying transaction. Therefore, taxes paid are usually classified as cash flows from operating activities. However, when it is practicable to identify the tax cash flow with an individual transaction that gives rise to cash flows that are classified as investing or financing activities the tax cash flow is classified as an investing or financing activity as appropriate.

Illustration 7

X Limited has paid an advance tax amounting to ₹ 5,30,000 during the current year. Out of the above paid tax, ₹ 30,000 is paid for tax on long term capital gains.

Under which activity the above said tax be classified in the cash flow statements of X Limited?

Solution

Cash flows arising from taxes on income should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities. In the case of X Limited, the tax amount of ₹ 30,000 is specifically related with investing activities.

₹ 5,00,000 to be shown under operating activities. ₹ 30,000 to be shown under investing activities.

*****

3.15 INVESTMENTS IN SUBSIDIARIES, ASSOCIATES AND JOINT VENTURES

When accounting for an investment in an associate, a joint venture or a subsidiary accounted for by use of the equity or cost method, an investor restricts its reporting in the statement of cash flows to the cash flows between itself and the investee, for example, to dividends and advances.

An entity that reports its interest in an associate or a joint venture using the equity method includes in its statement of cash flows the cash flows in respect of its investments in the associate or joint venture, and distributions and other payments or receipts between it and the associate or joint venture.

3.16 CHANGES IN OWNERSHIPS INTERESTS IN SUBSIDIARIES AND OTHER BUSINESSES

3.16.1 Classification of Cash Flows as Investing Activity

- The aggregate cash flows arising from obtaining or losing control of subsidiaries or other businesses shall be presented separately and classified as investing activities.
- An entity shall disclose, in aggregate, in respect of both obtaining and losing control of subsidiaries or other businesses during the period each of the following:

  (a) the total consideration paid or received;

  (b) the portion of the consideration consisting of cash and cash equivalents;

  (c) the amount of cash and cash equivalents in the subsidiaries or other businesses over which control is obtained or lost; and

  (d) the amount of the assets and liabilities other than cash or cash equivalents in the subsidiaries or other businesses over which control is obtained or lost, summarised by each major category.
- The separate presentation of the cash flow effects of obtaining or losing control of subsidiaries or other businesses as single line items, together with the separate disclosure of the amounts of assets and liabilities acquired or disposed of, helps to distinguish those cash flows from the cash flows arising from the other operating, investing and financing activities. The cash flow effects of losing control are not deducted from those of obtaining control.
- The aggregate amount of the cash paid or received as consideration for obtaining or losing control of subsidiaries or other businesses is reported in the statement of cash flows net of

cash and cash equivalents acquired or disposed of as part of such transactions, events or changes in circumstances.

3.16.2 Classification of Cash Flows as Financing Activity

- Cash flows arising from changes in ownership interests in a subsidiary that do not result in a loss of control shall be classified as cash flows from financing activities, unless the subsidiary is held by an investment entity and is required to be measured at fair value through profit or loss.
- Changes in ownership interests in a subsidiary that do not result in a loss of control, such as the subsequent purchase or sale by a parent of a subsidiary's equity instruments, are accounted for as equity transactions (see Ind AS 110), unless the subsidiary is held by an investment entity and is required to be measured at fair value through profit or loss. Accordingly, the resulting cash flows are classified in the same way as other transactions with owners.

3.17 NON-CASH TRANSACTIONS

- Investing and financing transactions that do not require the use of cash or cash equivalents shall be excluded from a statement of cash flows.
- Such transactions shall be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.
- Many investing and financing activities do not have a direct impact on current cash flows although they do affect the capital and asset structure of an entity. Such non-cash items will not form part of the cash flow statement.

  Examples of non-cash transactions are:

  (a) the acquisition of assets either by assuming directly related liabilities or by means of a lease;

  (b) the acquisition of an entity by means of an equity issue; and

  (c) the conversion of debt to equity

Illustration 8

X Limited acquires fixed asset of ₹ 10,00,000 from Y Limited by accepting the liabilities of ₹ 8,00,000 of Y Limited and balance amount it paid in cash. How X Limited will treat all those items in its cash flow statements?

Solution

Investing and financing transactions that do not require the use of cash and cash equivalents shall be excluded from a statement of cash flows. X Limited should classify cash payment of ₹ 2,00,000 under investing activities. The non-cash transactions – liabilities and asset should be disclosed in the notes to the financial statements.

*****

3.17.1 Changes in liabilities arising from financing activities

- An entity shall provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes.
- To the extent necessary to satisfy the above requirement, an entity shall disclose the following changes in liabilities arising from financing activities:
  (a) changes from financing cash flows;
  (b) changes arising from obtaining or losing control of subsidiaries or other businesses;
  (c) the effect of changes in foreign exchange rates;
  (d) changes in fair values; and
  (e) other changes.
- Liabilities arising from financing activities are liabilities for which cash flows were, or future cash flows will be, classified in the statement of cash flows as cash flows from financing activities.
- In addition, the disclosure requirement also applies to changes in financial assets (for example, assets that hedge liabilities arising from financing activities) if cash flows from those financial assets were, or future cash flows will be, included in cash flows from financing activities.
- One way to fulfil the disclosure requirement is by providing a reconciliation between the opening and closing balances in the balance sheet for liabilities arising from financing activities, including the changes identified.
- If an entity provides the disclosure required in combination with disclosures of changes in other assets and liabilities, it shall disclose the changes in liabilities arising from financing activities separately from changes in those other assets and liabilities.

3.18 COMPONENTS OF CASH AND CASH EQUIVALENTS

- An entity shall disclose the components of cash and cash equivalents and shall present a reconciliation of the amounts in its statement of cash flows with the equivalent items reported in the balance sheet.
- Company will provide a policy which it adopts in determining the composition of cash and cash equivalents (As per Ind AS 1).

It has been clarified, that there should not be a difference in the amount of cash and cash equivalent as per Ind AS 1 and as per Ind AS 7. However, as per Ind AS 7 "where bank overdrafts which are repayable on demand form an integral part of an entity's cash management, bank overdrafts are included as a component of cash and cash equivalents. A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn." Although Ind AS 7 permits bank overdrafts to be included as cash and cash equivalent, for the purpose of presentation in the balance sheet, it would not be appropriate to include bank overdraft in the line item cash and cash equivalents unless the netting off conditions as given in paragraph 42 of Ind AS 32, Financial Instruments: Presentation are complied with.

Bank overdraft, in the balance sheet, will be included within financial liabilities. Just because the bank overdraft is included in cash and cash equivalents for the purpose of Ind AS 7, does not mean that the same should be netted off against the cash and cash equivalent balance in the balance sheet. Instead Ind AS 7 requires a disclosure of the components of cash and cash equivalent and a reconciliation of amounts presented in the cash flow statements.

Another element on account of which there could be difference between the cash and cash equivalents presented in the balance sheet and the statement of cash flows is unrealised gains or losses arising from changes in foreign currency exchange rates, which are not considered to be cash flows. The following illustration would explain the issue:

Illustration 9

An entity has bank balance in foreign currency aggregating to USD 100 (equivalent to ₹ 4,500) at the beginning of the year. Presuming no other transaction taking place, the entity reported a profit before tax of ₹ 100 on account of exchange gain on the bank balance in foreign currency at the end of the year. What would be the closing cash and cash equivalents as per the balance sheet?

Solution

For the purpose of statement of cash flows, the entity shall present the following:

	Amount (₹)
Profit before tax	100
Less: Unrealised exchange gain	(100)
Cash flow from operating activities	Nil
Cash flow from investing activities	Nil
Cash flow from financing activities	Nil
Net increase in cash and cash equivalents during the year	Nil
Add: Opening balance of cash and cash equivalents	4,500

Cash and cash equivalents as at the year-end	4,500
Reconciliation of cash and cash equivalents	
Cash and cash equivalents as per statement of cash flows	4,500
Add: Unrealised gain on cash and cash equivalents	100
Cash and cash equivalents as per the balance sheet	4,600

If any changes in the policies take place, that will be dealt with as per the provisions of Ind AS 8.

*****

3.19 OTHER DISCLOSURES

An entity shall disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the entity that are not available for use by the group.

There are various circumstances in which cash and cash equivalent balances held by an entity are not available for use by the group. Examples include cash and cash equivalent balances held by a subsidiary that operates in a country where exchange controls or other legal restrictions apply when the balances are not available for general use by the parent or other subsidiaries.

Additional information may be relevant to users in understanding the financial position and liquidity of an entity. It may include:

1. The amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities.
2. The aggregate amount of cash flows that represent increases in operating capacity separately from those cash flows that are required to maintain operating capacity it will help the stakeholders to know whether entity is paying proper attention for maintenance also;
3. The amount of the cash flows arising from the operating, investing and financing activities of each reportable segment (see Ind AS 108, *Operating Segments)*. This will provide the idea about the company as a whole as well as the various parts of the company and their efficiencies.

Illustration 10

Following is the balance sheet of Kuber Limited for the year ended March 31, 20X2

(₹ in lacs)

	20X2	*20X1*
ASSETS		
Non-current Assets		
Property, plant and equipment	*13,000*	*12,500*

Intangible assets	50	30
Other financial assets	145	170
Deferred Tax Asset (net)	855	750
Other non-current assets	800	770
Total Non-current assets	14,850	14,220
Current Assets		
Financial assets		
Investments	2,300	2,500
Cash and cash equivalents	220	460
Other current assets	195	85
Total Current assets	2,715	3,045
Total Assets	17,565	17,265
EQUITY AND LIABILITIES		
Equity		
Equity share capital	300	300
Other equity	12,000	8,000
Total equity	12,300	8,300
Liabilities		
Non-current liabilities		
Long-term borrowings	2,000	5,000
Other non-current liabilities	2,740	3,615
Total non-current liabilities	4,740	8,615
Current liabilities		
Financial liabilities		
Trade payables	150	90
Bank Overdraft	75	60
Other current liabilities	300	200
Total current liabilities	525	350
Total liabilities	5,265	8,965
Total Equity and Liabilities	17,565	17,265

Additional Information:

(1) Profit after tax for the year ended March 31, 20X2 - ₹ 4,450 lacs

(2) Interim Dividend paid during the year - ₹ 450 lacs

(3) Depreciation and amortisation charged in the statement of profit and loss during the current year are as under

(a) Property, Plant and Equipment - ₹ 500 lacs

(b) Intangible Assets - ₹ 20 lacs

(4) During the year ended March 31, 20X2 two machineries were sold for ₹ 70 lacs. The carrying amount of these machineries as on March 31, 20X2 is ₹ 60 lacs.

(5) Income taxes paid during the year ₹ 105 lacs

(6) Other non-current/current assets and liabilities are related to operations of Kuber Ltd. and do not contain any element of financing and investing activities.

Using the above information of Kuber Limited, construct a statement of cash flows under indirect method.

Solution

Statement of Cash Flows

		₹ in lacs
Cash flows from Operating Activities		
Net Profit after Tax	4,450	
Add: Tax Paid	105	
	4,555	
Add: Depreciation& Amortisation (500 + 20)	520	
Less: Gain on Sale of Machine (70-60)	(10)	
Less: Increase in Deferred Tax Asset (855-750)	(105)	
	4,960	
Change in operating assets and liabilities		
Add: Decrease in financial asset (170 - 145)	25	
Less: Increase in other non-current asset (800 - 770)	(30)	
Less: Increase in other current asset (195 - 85)	(110)	
Less: Decrease in other non-current liabilities (3,615 – 2,740)	(875)	
Add: Increase in other current liabilities (300 - 200)	100	
Add: Increase in trade payables (150-90)	60	
	4,130	
Less: Income Tax	(105)	
Cash generated from Operating Activities		**4,025**

Cash flows from Investing Activities		
Sale of Machinery	70	
Purchase of Machinery [13,000-(12,500 – 500-60)]	(1,060)	
Purchase of Intangible Asset [50-(30-20)]	(40)	
Sale of Financial asset - Investment (2,500 – 2,300)	200	
Cash outflow from Investing Activities		**(830)**
Cash flows from Financing Activities		
Dividend Paid	(450)	
Long term borrowings paid (5,000 – 2,000)	(3,000)	
Cash outflow from Financing Activities		**(3,450)**
Net Cash outflow from all the activities		**(255)**
Opening cash and cash equivalents (460 – 60)		**400**
Closing cash and cash equivalents (220 – 75)		**145**

3.20 SIGNIFICANT DIFFERENCES IN IND AS 7 VIS-À-VIS AS 3

S. No.	Particulars	Ind AS 7	AS 3
1.	*Bank Overdraft Repayable on Demand*	Ind AS 7 specifically includes bank overdrafts which are repayable on demand as a part of cash and cash equivalents	AS 3 is silent on this aspect.
2.	*Treatment of Cash Payments in Specific Cases*	Ind AS 7 provides the treatment of cash payments to manufacture or acquire assets held for rental to others and subsequently held for sale in the ordinary course of business as cash flows from operating activities. Further, treatment of cash receipts from rent and subsequent sale of such assets as cash flow from operating activity is also provided.	AS 3 does not contain such requirements.

3.	*New Examples of Cash Flows arising from Financing Activities*	Ind AS 7 includes the following new examples of cash flows arising from financing activities: (a) cash payments to owners to acquire or redeem the entity's shares (b) cash proceeds from mortgages (c) cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease.	AS 3 does not contain such examples.
4.	*Adjustment of the Profit or Loss for the Effects of Undistributed Profits of Associates and Non-controlling Interests*	Ind AS 7 specifically requires adjustment of the profit or loss for the effects of 'undistributed profits of associates and non-controlling interests' while determining the net cash flow from operating activities using the indirect method.	AS 3 does not contain such requirements.
5.	*Cash Flows associated with Extraordinary Activities*	Ind AS 7 does not contain this requirement.	AS 3 requires cash flows associated with extraordinary activities to be separately classified as arising from operating, investing and financing activities
6.	*Disclosure of the Amount of Cash and Cash Equivalents in Specific Situations*	Ind AS 7 requires an entity (except an investment entity) to disclose the amount of cash and cash equivalents and other assets and liabilities in the subsidiaries or other businesses over which control is obtained or lost. It also requires to report the aggregate amount of the cash paid or received as consideration for obtaining or losing control of	AS 3 does not contain such requirements.

		subsidiaries or other businesses in the statement of cash flows, net of cash and cash equivalents acquired or disposed of as a part of such transactions, events or changes in circumstances.	
7.	*Cash Flows arising from Changes in Ownership Interests in a Subsidiary*	Ind AS 7 requires to classify cash flows arising from changes in ownership interests in a subsidiary that do not result in a loss of control as cash flows from financing activities.	AS 3 does not contain such a requirement.
8.	*Investment in Subsidiaries, Associates and Joint Ventures (Investees)*	Ind AS 7 mentions the use of equity or cost method while accounting for an investment in an associate, joint venture or a subsidiary. It also specifically deals with the reporting of interest in an associate or a joint venture using equity method.	AS 3 does not contain such requirements.
9.	*Use of Different Terminology and Translation of Cash Flows of a Foreign Subsidiary*	Ind AS 7 uses the term 'functional currency' instead of 'reporting currency' (as used in AS 3). It also deals with translation of cash flows of a foreign subsidiary.	AS 3 does not dealt with these.
10.	*Disclosures*	Ind AS 7 requires more disclosures.	Disclosure requirement in AS 3 are less.

TEST YOUR KNOWLEDGE

Questions

1. Use the following data of ABC Ltd. to construct a statement of cash flows using the direct and indirect methods:

(Amount in ₹)

	20X2	20X1
Cash	4,000	14,000
Accounts Receivable	25,000	32,500
Prepaid Insurance	5,000	7,000
Inventory	37,000	34,000
Fixed Assets	3,16,000	2,70,000
Accumulated Depreciation	(45,000)	(30,000)
Total Assets	3,42,000	3,27,500
Accounts Payable	18,000	16,000
Wages Payable	4,000	7,000
Debentures	1,73,000	1,60,000
Equity Shares	88,000	84,000
Retained Earnings	59,000	60,500
Total Liabilities & Equity	3,42,000	3,27,500
	20X2	
Sales	2,00,000	
Cost of Goods Sold	(1,23,000)	
Depreciation	(15,000)	
Insurance Expense	(11,000)	
Wages	(50,000)	
Net Profit	1,000	

During the financial year 20X2 company ABC Ltd. declared and paid dividends of ₹ 2,500.

During 20X2, ABC Ltd. paid ₹ 46,000 in cash to acquire new fixed assets. The accounts payable was used only for inventory. No debt was retired during 20X2.

2. From the following summary cash account of XYZ Ltd, prepare cash flow statement for the year ended March 31, 20X1 in accordance with Ind AS 7 using direct method.

Summary of Bank Account for the year ended March 31, 20X1

	₹ '000		₹ '000
Balance on 1.4.20X0	50	Payment to creditors	2,000
Issue of Equity Shares	300	Purchase of Fixed Assets	200
Receipts from customers	2,800	Overhead Expenses	200
Sale of Fixed Assets	100	Payroll	100
		Tax Payment	250
		Dividend	50
		Repayment of Bank loan	300
		Balance on 31.3.20X1	150
	3,250		3,250

3. Z Ltd. has no foreign currency cash flow for the year 2017. It holds some deposit in a bank in the USA. The balances as on 31.12.2017 and 31.12.2018 were US $ 100,000 and US $ 102,000 respectively. The exchange rate on December 31, 2017 was US $ 1 = ₹ 45. The same on 31.12.2018 was US $ 1 = ₹ 50. The increase in the balance was on account of interest credited on 31.12.2018. Thus, the deposit was reported at ₹ 45,00,000 in the balance sheet as on December 31, 2017. It was reported at ₹ 51,00,000 in the balance sheet as on 31.12.2018. How these transactions should be presented in cash flow for the year ended 31.12.2018 as per Ind AS 7?

Answers

1. **A. DIRECT METHOD**

Cash flows from operating activities		**20X2**
Cash received from customers	2,07,500	
Cash paid for inventory	(1,24,000)	
Cash paid for insurance	(9,000)	
Cash paid for wages	(53,000)	
Net cash flow from operating activities		21,500
Cash flows from investing activities		
Purchase of fixed assets		(46,000)

Cash flows from financing activities		
Dividend paid	(2,500)	
Proceeds from issuance of debentures	13,000	
Proceeds from issue of equity	4,000	
Net cash flows from financing activities		14,500
Net decrease in cash and cash equivalents		**(10,000)**
Opening Cash Balance		**14,000**
Closing Cash Balance		**4,000**

B. INDIRECT METHOD

Cash flows from operating activities		20X2
Net Profit	1,000	
Adjustments for Depreciation	15,000	
	16,000	
Decrease in accounts receivable	7,500	
Decrease in prepaid insurance	2,000	
Increase in inventory	(3,000)	
Increase in accounts payable	2,000	
Decrease in wages payable	(3,000)	
Net cash flow from operating activities		21,500
Cash flows from investing activities		
Purchase of fixed assets		(46,000)
Cash flows from financing activities		
Dividend paid	(2,500)	
Proceeds from issue of debentures	13,000	
Proceeds from issue of equity	4,000	
Net cash flows from financing activities		14,500
Net decrease in cash and cash equivalents		**(10,000)**
Opening Cash Balance		**14,000**
Closing Cash Balance		**4,000**

Working notes:

Fixed Assets Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	2,70,000	By Balance c/d	3,16,000
To Cash (Purchase of Fixed Assets)	46,000		
	3,16,000		3,16,000

Inventory Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	34,000	By Cost of goods sold	1,23,000
To Creditors account (credit purchase)	2,000	By Balance c/d	37,000
To Purchase (Bal. Figure)	1,24,000		
	1,60,000		**1,60,000**

Accounts Payable Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance c/d	18,000	By Balance b/d	16,000
		By Inventory Account (credit purchase) (Bal.Fig.)	2,000
	18,000		**18,000**

Equity Share Capital Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Bal. c/d	88,000	By Balance b/d	84,000
		By Bank account (Proceeds from equity share issued)	4,000
	88,000		**88,000**

2. **XYZ Ltd.**

Cash Flow Statement for the year ended March 31, 20X1 (Using the Direct Method)

Cash flows from operating activities	₹ '000	₹ '000
Cash receipts from customers	2,800	
Cash payments to suppliers	(2,000)	
Cash paid to employees	(100)	
Cash payments for overheads	(200)	
Cash generated from operations	500	
Income tax paid	(250)	
Net cash from operating activities		250
Cash flow from investing activities		
Payments for purchase of fixed assets	(200)	
Proceeds from sale of fixed assets	100	
Net cash used in investing activities		(100)
Cash flows from financing activities		
Proceeds from issuance of equity shares	300	
Bank loan repaid	(300)	
Dividend paid	(50)	
Net cash used in financing activities		*(50)*
Net increase in cash		**100**
Cash at the beginning of the period		**50**
Cash at end of the period		**150**

3. The profit and loss account was credited by ₹ 1,00,000 (US$ 2000 × ₹ 50) towards interest income. It was credited by the exchange difference of US$ 100,000 × (₹ 50 - ₹45) that is, ₹ 500,000. In preparing the cash flow statement, ₹ 500,000, the exchange difference, should be deducted from the 'net profit before taxes, and extraordinary item'. However, in order to reconcile the opening balance of the cash and cash equivalents with its closing balance, the exchange difference ₹ 500,000, should be added to the opening balance in note to cash flow statement.

Cash flows arising from transactions in a foreign currency shall be recorded in Z Ltd.'s functional currency by applying to the foreign currency amount the exchange rate between the functional currency and the foreign currency at the date of the cash flow.

CHAPTER 3

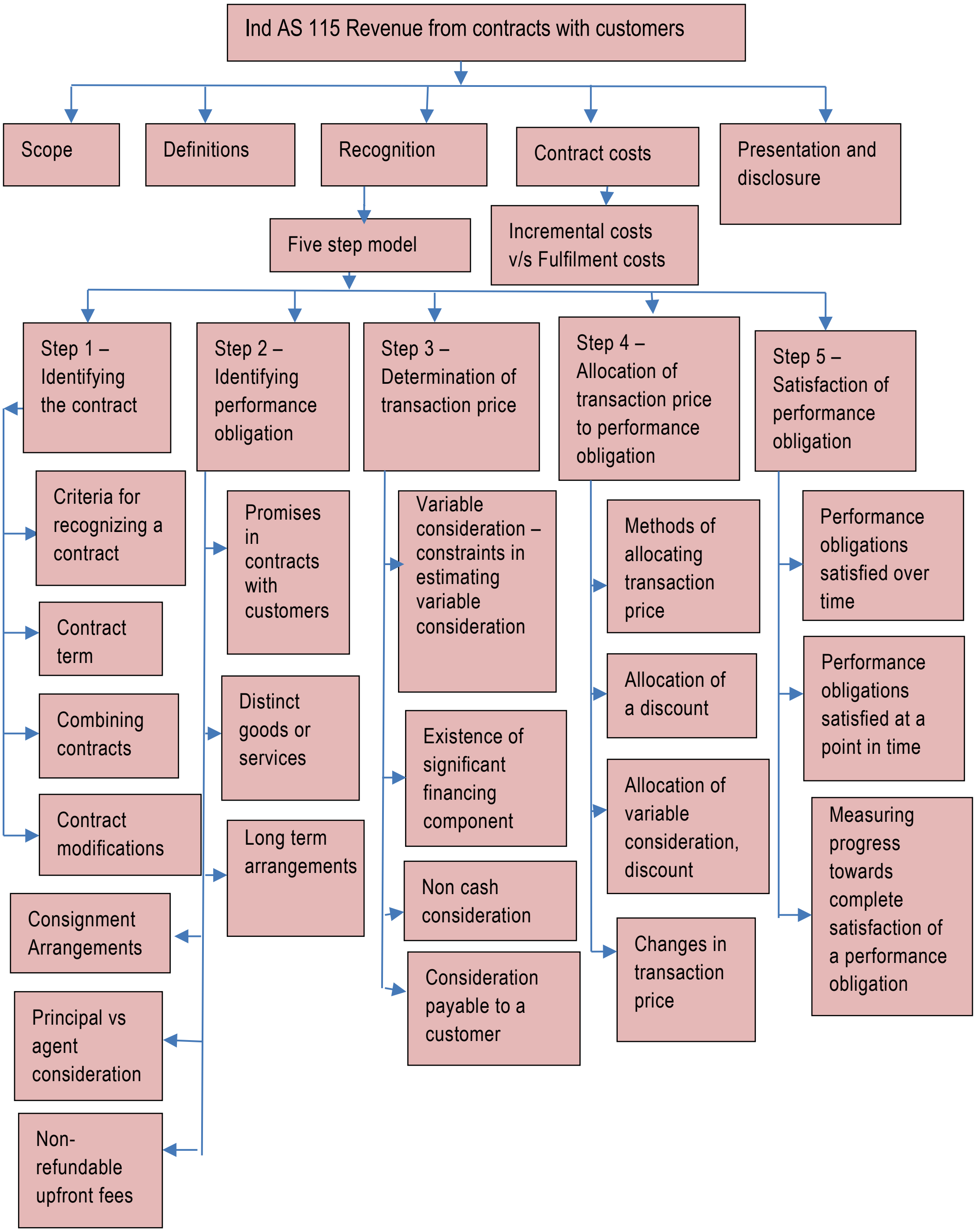
IND AS 115 REVENUE FROM CONTRACTS WITH CUSTOMERS

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Appreciate the scope and definition of the standard.
- Identify the contract.
- Comprehend the criteria for revenue recognition.
- Gain knowledge on accounting treatment of various aspects like combination of contracts, contract modifications etc.
- Identify performance obligations and when the performance obligation is satisfied.
- Determine the transaction price and allocate the performance obligation to transaction price.
- Allocate discount to various performance obligations in determining their transaction price.
- Account for the changes in the transaction price.
- Account for variable considerations while determining the transaction price.
- Deal with contract costs.
- Comply with the Presentation and disclosure requirements of the standard.

CHAPTER OVERVIEW



This standard establishes principles to report useful information about the nature, amount, timing and uncertainty of revenue and cash flows arising from a contract with a customer.

The core principle is that an entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

The standard specifies the accounting for an individual contract with a customer. However, as a practical expedient, an entity may apply this Standard to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects of applying the Standard to the portfolio would not differ materially from applying this Standard to the individual contracts (or performance obligations) within that portfolio.

1. SCOPE

Ind AS 115 applies to all contracts with customers to provide goods or services that are outputs of the entity's ordinary course of business in exchange for consideration, unless specifically excluded from the scope of the new guidance, as described below.

An entity shall apply this Standard to all contracts with customers, except the following:

(a) lease contracts within the scope of ***Ind AS 116, Leases***;

(b) insurance contracts within the scope of Ind AS 104, Insurance Contracts

(c) financial instruments and other contractual rights or obligations within the scope of Ind AS 109, Financial Instruments, Ind AS 110, Consolidated Financial Statements, Ind AS 111, Joint Arrangements, Ind AS 27, Separate Financial Statements and Ind AS 28, Investments in Associates and Joint Ventures; and

(d) non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. For example, this Standard would not apply to a contract between two oil companies that agree to an exchange of oil to fulfil demand from their customers in different specified locations on a timely basis.

This standard is applicable only if the counterparty to the contract is a customer. A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

A counterparty to the contract would not be a customer if, for example, the counterparty has contracted with the entity to participate in an activity or process in which the parties to the contract share in the risks and benefits that result from the activity or process (such as developing an asset in a collaboration arrangement) rather than to obtain the output of the entity's ordinary activities.

A contract with a customer may be partially within the scope of Ind AS 115 and partially within the scope of other Ind AS. In such cases, the following steps should be followed to identify how it should be split between Ind AS 115 and other Ind AS:

(i) If the other Ind AS specify how to separate and/or measure a portion of the contract, then that guidance should be applied first. The amounts measured under other Ind AS should be excluded from the transaction price that is allocated to performance obligations under Ind AS 115.

(ii) If the other Ind AS do not stipulate how to separate and/or measure a portion of the contract, then Ind AS 115 would be used to separate and/or measure that portion of the contract (refer discussion relating to Step 4 - Allocation of transaction price to performance obligation).

Ind AS 115 also specifies the accounting for the incremental costs of obtaining a contract with a customer and for the costs incurred to fulfil a contract with a customer if those costs are not within the scope of another Standard (see section related to Contract Costs). An entity shall apply those paragraphs only to the costs incurred that relate to a contract with a customer (or part of that contract) that is within the scope of this Standard.

2. DEFINITIONS

Contract	An agreement between two or more parties that creates enforceable rights and obligations.
Contract asset	An entity's right to consideration in exchange for goods or services that the entity has transferred to a **customer** when that right is conditioned on something other than the passage of time (for example, the entity's future performance).
Contract liability	An entity's obligation to transfer goods or services to a **customer** for which the entity has received consideration (or the amount is due) from the customer.
Customer	A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.
Income	Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity, other than those relating to contributions from equity participants.
Performance obligation	A promise in a **contract** with a **customer** to transfer to the customer either: (a) a good or service (or a bundle of goods or services) that is distinct; or

	(b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.
Revenue	**Income** arising in the course of an entity's ordinary activities.
Stand-alone selling price (of a good or service)	The price at which an entity would sell a promised good or service separately to a **customer**.
Transaction price (for a contract with a customer)	The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a **customer**, excluding amounts collected on behalf of third parties.

3. OVERVIEW

After more than a decade of work, the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) had published their largely converged standards on revenue recognition in May, 2014. The IASB issued IFRS 15 Revenue from Contracts with Customers and FASB issued ASU 2014-09 with the same name.

In convergence with IFRS, the Ministry of Corporate Affairs (MCA) issued Ind AS 115, Revenue from Contracts with Customers vide its notification dated 28th March, 2018.

Ind AS 115 supersedes and replaces Ind AS 11 and Ind AS 18.

Ind AS 115 is based on a core principle that requires an entity to recognise revenue:

(a) In a manner that depicts the transfer of goods or services to customers

(b) At an amount that reflects the consideration the entity expects to be entitled to in exchange for those goods or services.

To achieve the core principle, an entity should apply the following five-step model:

Step 1: Identify the contract with the customer.

Step 2: Identify the performance obligations in the contract.

Step 3: Determine the transaction price.

Step 4: Allocate the transaction price to the performance obligations in the contract.

Step 5: Recognize revenue when (or as) the entity satisfies its performance obligations.

Identify the contract(s) with a customer

↓

Identify the performance obligations

↓

Determine the transaction price

↓

Allocate the transaction price to the performance obligations

↓

Recognise revenue when or as an entity satisfies performance obligations

Each of these steps, and some other related guidance, is discussed in details below.

4. TRANSITION

Ind AS 115 is effective for annual reporting periods beginning on or after 1st April, 2018.

Entities are required to apply the new revenue standard using either of the following two approaches:

(a) Full retrospective approach: retrospectively to each prior period presented in accordance with Ind AS 8, subject to some practical expedients mentioned in the standard or

(b) Modified retrospective approach: retrospectively with the cumulative effect of initial application recognised at the date of initial application

When applying the full retrospective method, an entity shall restate all prior periods presented in accordance with Ind AS 8. This results in comparative statements in which all periods are presented as if Ind AS 115 had been in effect since the beginning of the earliest period presented.

When applying modified retrospective approach, an entity does not restate prior periods presented and the cumulative effect of initial application is recognised in the opening retained earnings of the first year of application of Ind AS 115.

5. STEP 1: IDENTIFYING THE CONTRACT

As the guidance in Ind AS 115 applies only to contracts with customers, the first step in the model is to identify such contracts.

A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral, or implied by an entity’s customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries, and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining whether and when an agreement with a customer creates enforceable rights and obligations.

The guidance in Ind AS makes it clear that the rights and obligations in a contract must be "enforceable" in order for an entity to apply the five-step revenue model. Enforceability is a matter of law, so an entity needs to consider the local relevant legal environment to make that determination. That said, while the contract must be legally enforceable, oral or implied promises may give rise to performance obligations in the contract.

5.1 Criteria for recognizing a contract

Step 1 serves as a 'gateway' through which an entity must pass before proceeding to the later steps of the model. In other words, if at the inception of an arrangement, an entity concludes that the criteria below are not met, it should not apply Steps 2 through 5 of the model until it determines that the Step 1 criteria are subsequently met. When a contract meets the five criteria and 'passes' Step 1, the entity will not reassess the Step 1 criteria unless there is an indication of a significant change in facts and circumstances.

An accounting contract exists only when an arrangement with a customer meets each of the following five criteria:

(a) The parties have approved (in writing, orally or in accordance with other customary business practices) the contract and are committed to perform their contractual obligations

(b) The entity can identify each party's rights regarding the goods or services to be transferred

(c) The entity can identify the payment terms for the goods or services to be transferred

(d) The contract has commercial substance (i.e. the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract), and

(e) It is probable that the entity will collect substantially all of the consideration to which it expects to be entitled.

If the arrangement does not meet the five criteria at inception, an accounting contract, for purposes of applying Ind AS 115, does not exist, and the entity should continue to reassess whether the five criteria are subsequently met. For example, if a customer's ability to pay the consideration deteriorates significantly, an entity would reassess whether it is probable that the entity will collect the consideration to which the entity will be entitled in exchange for the remaining goods or services that will be transferred to the customer.

A contract may not pass Step 1, but the entity may still transfer goods or services to the customer and receive non-refundable consideration in exchange for those goods or services. In that circumstance, the entity cannot recognise revenue for the non-refundable consideration received until either the Step 1 criteria are subsequently met, or one of the events outlined below has occurred:

(a) The entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is non-refundable, or

(b) The contract has been terminated, and the consideration received from the customer is non-refundable.

Consider if the contract meets each of the five criteria to pass Step 1:

Have the parties approved the contract? → No

↓ Yes

Can the entity identify each party's rights regarding the goods/services to be transferred? → No

↓ Yes

Can the entity identify the payment terms for the goods/services to be transferred? → No

↓ Yes

Does the contract have commercial substance? → No

↓ Yes

Is it probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods/services that will be transferred to the customer? → No

↓ Yes

Proceed to Step 2 and only reassess the Step 1 criteria if there is an indication of a significant change in facts and circumstances.

Recognise consideration received as a liability until each of the five criteria in Step 1 are met or one of the following occurs:

1. entity has no remaining performance obligations and substantially all consideration has been received and is non-refundable.
2. contract is terminated and consideration is non-refundable

↑

Continue to assess the contract to determine if the Step 1 criteria are met. → (back to: Consider if the contract meets each of the five criteria to pass Step 1)

Each of the criteria mentioned above are discussed in more detail below:

5.1.1 Criteria 1: The parties have approved the contract and are committed to perform

To pass Step 1, the parties must approve the contract. This approval may be written, oral, or implied, as long as the parties intend to be bound by the terms and conditions of the contract.

The parties should also be committed to performing their respective obligations under the contract. This does not mean that the parties need to be committed to fulfil all of their respective rights and obligations in order for this criterion to be met. For example, an entity may include a requirement in a contract for the customer to purchase a minimum quantity of goods each month, but the entity may have a history of not enforcing the requirement. In this example, the contract approval criterion can still be satisfied if evidence supports that the customer and the entity are both substantially committed to the contract.

5.1.2 Criteria 2: The entity can identify each party's rights

An entity must be able to identify its rights, as well as the rights of all other parties to the contract. An entity cannot assess the transfer of goods or services if it cannot identify each party's rights regarding those goods or services.

5.1.3 Criteria 3: The entity can identify the payment terms for the goods or services

An entity must also be able to identify the payment terms for the promised goods or services within the contract. The entity cannot determine how much it will receive in exchange for the promised goods or services (the "transaction price" in Step 3 of the model) if it cannot identify the contractual payment terms.

5.1.4 Criteria 4: The contract has commercial substance

A contract has commercial substance if the risk, timing, or amount of the entity's cash flows is expected to change as a result of the contract. In other words, the contract must have economic consequences. This criterion was added to prevent entities from transferring goods or services back and forth to each other for little or no consideration to artificially inflate their revenue. This criterion is applicable for both monetary and nonmonetary transactions, because without commercial substance, it is questionable whether an entity has entered into a transaction that has economic consequences.

5.1.5. Criteria 5: It is probable the entity will collect substantially all of the consideration

To pass Step 1, an entity must determine that it is probable that it will collect substantially all of the consideration to which it will be entitled under the contract in exchange for goods or services that it will transfer to the customer. This criterion is also referred to as the 'collectability assessment'. In determining whether collection is probable, the entity considers the customer's ability and intention to pay when amounts are due. In making the determination of customer's ability to pay, the credit risk was an important thing to determine if the contract is valid. However, customer's credit risk should not affect the measurement or presentation of revenue.

Illustration 1

New way limited decides to enter a new market that is currently experiencing economic difficulty and *expects that in future economy will improve. New way enters into an arrangement with a customer in the new region for networking products for promised consideration of ₹ 1,250,000. At contract inception, New way expects that it may not be able to collect the full amount from the customer.*

Determine how New way will recognise this transaction?

Solution

Assuming the contract meets the other criteria covered within the scope of the model in Ind AS 115, New way need to assesses whether collectability is probable.

In making this assessment, New way considers whether the customer has the ability and intent to pay the estimated transaction price, which may be an amount less than the contract price.

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5.2 Contracts that do not pass Step 1: Reassessing the Step 1 criteria

When an entity determines that a contract passes Step 1, it should not reassess contract existence unless there is an indication of a significant change in facts and circumstances.

When the entity concludes that collectability is no longer probable, only the revenue related to the remaining goods or services yet to be transferred is impacted. Other than impairment considerations, the reassessment has no impact on revenue recognized to date, receivables recorded, or assets recognized as a result of satisfied performance obligations.

5.3 Contract term

An entity applies Ind AS 115 to the contractual period over which the parties to the contract have present enforceable rights and obligations.

Some contracts with customers may have no fixed duration and can be terminated or modified by either party at any time. Other contracts may automatically renew on a periodic basis that is specified in the contract. An entity shall apply this Standard to the duration of the contract (ie the contractual period) in which the parties to the contract have present enforceable rights and obligations.

5.3.1 Termination provisions

Some contracts can be terminated by either party at any time while others may only be terminated by one party. An accounting contract does not exist if each party to a contract has the unilateral enforceable right to terminate a wholly unperformed contract without paying a termination penalty. A 'wholly unperformed' contract means that the entity hasn't yet performed and is not entitled to any consideration.

In some situations, only the customer has the ability to terminate the contract without penalty. In those situations, the contract term for accounting purposes may be shorter than the stated contract term.

Illustration 2

A gymnasium enters into a contract with a new member to provide access to its gym for a 12-month period at ₹ 4,500 per month. The member can cancel his or her membership without penalty after three months. Specify the contract term.

Solution

The enforceable rights and obligations of this contract are for three months, and therefore the contract term is three months.

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5.4 Combining contracts

An entity should combine two or more contracts and account for them as a single contract in certain circumstances because the substance of the individual contracts cannot be understood without considering the entire arrangement. This evaluation takes place at contract inception.

Two or more contracts may need to be accounted for as a single contract if they are entered into at or near the same time with the same customer (or with related parties), and if one of the following conditions exists:

(a) The contracts are negotiated as a package with a single commercial objective;

(b) The amount of consideration paid in one contract depends on the price or performance in the other contract; or

(c) The goods or services promised in the contract are a single performance obligation.

Illustration 3

Manufacturer of airplanes for the air force negotiates a contract to design and manufacture new fighter planes for a Kashmir air base. At the same meeting, the manufacturer enters into a separate contract to supply parts for existing planes at other bases.

Would these contracts be combined?

Solution

Contracts were negotiated at the same time, but they appear to have separate commercial objectives. Manufacturing and supply contracts are not dependent on one another, and the planes and the parts are not a single performance obligation. Therefore, contracts for supply of fighter planes and supply of parts shall not be combined and instead, they shall be accounted separately.

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5.5 Contract Modifications

Modifications that change the terms of a contract are common in many industries, including manufacturing, telecommunications, defence, and construction. Depending upon the industry or jurisdiction, the modification may be better known as a change order, a variation, or an amendment.

The modification guidance under Ind AS 115 requires an entity to

(a) Identify if a contract has been modified.

(b) Determine if the modification results in a separate contract, a termination of the existing contract and the creation of a new contract, or a continuation of the existing contract.

(c) Account for the contract modification accordingly.

5.5.1 Identifying a modification

A contract modification exists if three conditions are met:

(a) There is a change in the scope, price, or both in a contract.

(b) That change is approved by both the entity and the customer.

(c) The change is enforceable.

Similar to the criterion discussed above, the approval of a contract modification may be written, oral, or implied by customary business practice.

Contract modifications may take many forms and the following list includes some common examples:

(a) Partially terminating the contract

(b) Extending the contract term with a corresponding increase in price

(c) Adding new goods and/or services to the contract, with or without a corresponding change in price

(d) Reducing the contract price without a change in goods or services promised

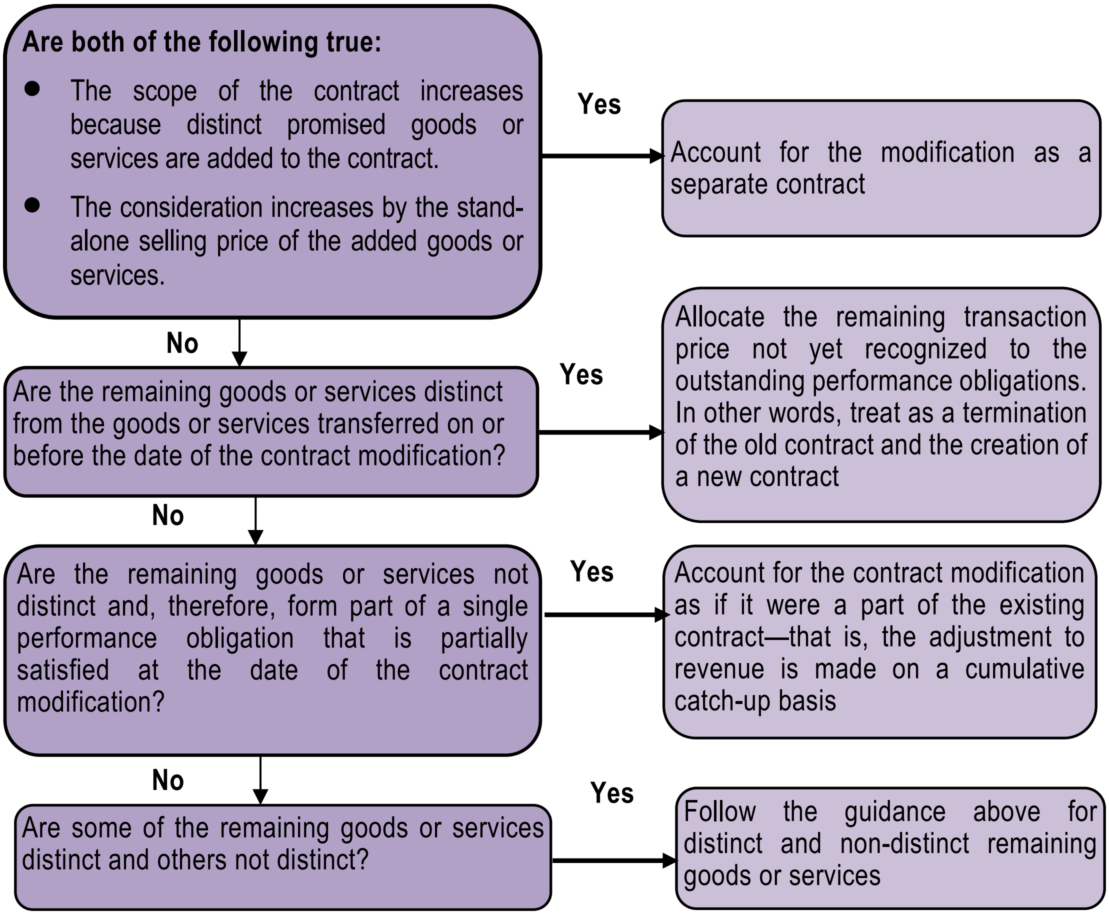
5.5.2 Accounting for the modification

Once an entity determines that a contract with a customer has been modified, it needs to determine whether the modification should be accounted for as a separate contract as discussed above. If the modification is not accounted for as a separate contract, it will be accounted for in one of the following three ways:

(a) As a termination of the old contract and the creation of a new contract

(b) By making a cumulative catch-up adjustment to the original contract

(c) A combination of the two



5.5.2.1 Modifications that constitute separate contracts

An entity accounts for a contract modification as a separate contract if the modification both (1) increases the scope of the work promised under the original contract by adding new promised goods or services that are considered distinct, and (2) the increase in the contract price reflects the stand-alone selling price of the additional goods or services. An entity determines if the additional promised goods or services are distinct using the guidance in Section 6.1.

The logic behind this guidance is that there is no economic difference between the entity entering into a separate contract or modifying an existing contract for the additional goods or services.

When assessing whether the transaction price increases by an amount of consideration that reflects the stand-alone selling prices of the additional goods or services, an entity is allowed to adjust the stand-alone selling price for costs that it does not incur because it is contracting with a repeat customer. Therefore, if the stand-alone selling price in the original contract is ₹ 10 per unit, a modification that adds units for ₹ 9.50 per unit might reflect a stand-alone selling price of the additional units. For example, the selling effort and administration costs might be much lower when incremental units are added, in contrast to the effort and cost of the original quantity. The entity needs to exercise judgment to make that determination.

If a modification adds a distinct good or service to a series of distinct goods or services that is accounted for as a single performance obligation, the modification is accounted for as a separate contract as long as the transaction price increases by the stand-alone selling price for those added goods or services.

Illustration 4

An entity promises to sell 120 products to a customer for ₹ 120,000 (₹ 1,000 per product). The products are transferred to the customer over a six-month period. The entity transfers control of each product at a point in time. After the entity has transferred control of 60 products to the customer, the contract is modified to require the delivery of an additional 30 products (a total of 150 identical products) to the customer at a price of ₹ 950 per product which is the standalone selling price for such additional products at the time of placing this additional order. The additional 30 products were not included in the initial contract.

It is assumed that additional products are contracted for a price that reflects the stand-alone selling price.

Determine the accounting for the modified contract?

Solution

When the contract is modified, the price of the contract modification for the additional 30 products is an additional ₹ 28,500 or ₹ 950 per product. The pricing for the additional products reflects the stand-alone selling price of the products at the time of the contract modification and the additional products are distinct from the original products.

Accordingly, the contract modification for the additional 30 products is, in effect, a new and separate contract for future products that does not affect the accounting for the existing contract and ₹ 950 per product for the 30 products in the new contract.

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5.5.2.2 Modifications that do not constitute separate contracts

If a contract modification is not accounted for as a separate contract, the guidance provides the following three methods to account for the modification:

(a) First, account for the modification prospectively as long as the goods or services to be provided after the modification are distinct from the goods or services that were already provided to the customer. The logic behind this guidance is that accounting for these types of modifications on a cumulative catch-up basis could be complex and may not faithfully depict the economics of the modification, since the modification is negotiated based on facts and circumstances that exist after the original contract's inception.

Illustration 5

On 1st April, 20X1, KLC Ltd. enters into a contract with Mr. K to provide

- *A machine for ₹ 2.5 million*
- *One year of maintenance services for ₹ 55,000 per month*

On 1st October, 20X1, KLC Ltd. and Mr. K agree to modify the contract to reduce the amount of services from ₹ 55,000 per month to ₹ 45,000 per month.

Determine the effect of change in the contract?

Solution

The next six months of services are distinct from the services provided in the first six months before modification in contract,

Therefore, KLC Ltd. will account for the contract modification as if it were a termination of the existing contract and the creation of a new contract.

The consideration allocated to remaining performance obligation is ₹ 270,000, which is the sum of

- The consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and had not yet been recognized as revenue. This amount is zero.
- The consideration promised as part of the contract modification ie ₹ 270,000.

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(b) Second, when the remaining goods or services are not distinct and are part of a single performance obligation that is partially satisfied, the entity recognizes the effect of the modification on a cumulative catch-up basis. This is the case in many construction contracts where a modification does not result in the transfer of additional distinct goods or services.

Illustration 6

Growth Ltd enters into an arrangement with a customer for infrastructure outsourcing deal.

Based on its experience, Growth Ltd determines that customising the infrastructure will take approximately 200 hours in total to complete the project and charges ₹ 150 per hour.

After incurring 100 hours of time, Growth Ltd and the customer agree to change an aspect of the project and increases the estimate of labour hours by 50 hours at the rate of ₹ 100 per hour.

Determine how contract modification will be accounted as per Ind AS 115?

Solution

Considering that the remaining goods or services are not distinct, the modification will be accounted for on a cumulative catch up basis, as given below:

Particulars	Hours	Rate (₹)	Amount (₹)
Initial contract amount	200	150	30,000
Modification in contract	50	100	5,000
Contract amount after modification	250	140*	35,000
Revenue to be recognised	100	140	14,000
Revenue already booked	100	150	15,000
Adjustment in revenue			(1,000)

*35,000 / 250 = 140

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(c) Third, there may be cases where the remaining goods or services provided after a modification are a combination of both distinct and non-distinct goods or services. In this case, the entity accounts for those remaining goods or services that are distinct on a prospective basis and for those goods and services that are not distinct on a cumulative catch-up basis.

6. STEP 2: IDENTIFYING PERFORMANCE OBLIGATIONS

Under the five step model of Ind AS 115, the second step in accounting for a contract with a customer is identifying the performance obligations. Identifying performance obligations is a crucial process in the five step model. Performance obligations are considered as unit of account for the purposes of applying the revenue standard. Identification of performance obligations requires high degree of judgment in cases where multiple goods or services are promised in a contract. Also it needs to be determined whether those performance obligations should be accounted for separately or as in combination with other promised goods or services in the contract.

The concept of performance obligations is a cornerstone of the Ind AS 115 revenue recognition model. The timing of revenue recognition is based on satisfaction of performance obligations rather than the contract as a whole. This area is sometimes referred to as 'multiple element arrangements'.

6.1 Criteria for identifying performance obligation

At contract inception, an entity shall assess

(a) the goods or services promised in a contract with a customer and

(b) shall identify performance obligation under each promise to be transferred to the customer.

A contract with a customer generally states explicitly, the goods or services that an entity promises to transfer to the customer. However, the performance obligations identified in a contract with the customer may not be limited to the goods or services that are explicitly stated in that contract. This is because a contract with a customer may also include promises that are implied by an entity's customary business practices, published policies or specific statements if, at the time of entering into the contract, those promises create a valid expectation of the customer that the entity will transfer a good or service to the customer. Therefore, performance obligations under a contract with the customer are not always explicit or clearly mentioned in the contract, but there can be implied promises or performance obligation under the contract as well.

Promises under the contract can be explicit or implicit if the same creates a valid expectation by the customer that the entity will provide those good or service based on the customary business practices, published policies, or specific statements. Some of the examples of promised goods or services include:

Promise	Example
• Sale of manufactured goods	• A manufacturing entity sells inventory
• Resale of goods purchased	• A retail entity sells purchased merchandise
• Resale of rights to goods or services purchased by an entity	• A hospitality entity that purchased a concert ticket resells the ticket, acting as principal
• Performing tasks	• A professional services entity provides consulting services
• Providing goods or services to customers on stand-by basis i.e. as and when required	• A manufacturing entity provides maintenance services on machines sold to a customer when the customer decides it wants the services performed
• Construction of an asset for the customers	• A contractor builds a hospital
• Use or access to intellectual property rights of the entity	• An entity grants a license to use its trade name
• Right to purchase additional goods or services to the customer in the future	• A retailer grants a customer an option to buy three items and to receive 60 percent off of a fourth item at a later date

Example

An entity, a manufacturer, sells a product to a distributor (i.e. its customer) who will then resell it to an end customer.

I Explicit promise of service

- The entity promises to the distributor to provide maintenance services for no additional consideration or free of cost to any party that purchases the product from the distributor. The entity in turn appoints the distributor and pays the distributor to provide the maintenance services on company's behalf to the customer for an agreed payment. In case no one avails those services, the company is not required to pay anything to the distributor.
- Under this contract promise to provide maintenance services in the future will be

considered as a performance obligation. The entity, has promised to provide maintenance services regardless of whether the entity, the distributor, or a third party provides the service.

II Implicit promise of service

- The entity has historically provided maintenance services for no additional consideration (i.e. 'free') to end customers that purchase the entity's product from the distributor. The entity does not explicitly promise maintenance services during negotiations with the distributor and the final contract between the entity and the distributor does not specify terms or conditions for those services.

- However, on the basis of its customary business practice, the entity determines at contract inception that it has made an implicit promise to provide maintenance services as part of the negotiated exchange with the distributor. That is, the entity's past practices of providing these services create valid expectations of the entity's customers (i.e. the distributor and end customers).

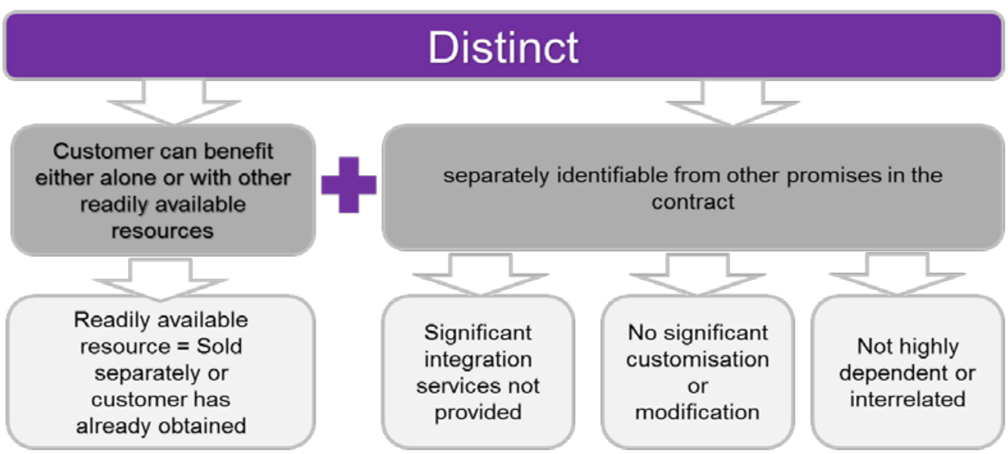
Performance obligations has been defined as a promise in a contract with a customer to transfer to the customer either:

(a) good or service (or a bundle of goods or services) that is distinct; or

(b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer. Performance obligations do not include activities that an entity must undertake to fulfil a contract unless those activities transfer a good or service to a customer. For example, a services provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed. Therefore, those setup activities are not a performance obligation.

A. Distinct performance obligations

A good or service that is promised to a customer is distinct if both of the following criteria are met:



Each of the criteria mentioned above are discussed in more detail below:

6.1.1 Customer can benefit either alone or with other readily available resources

The customer can benefit from the good or service either on its own or with other resources readily available to them. A readily available resource is a good or service that is sold separately (by the entity or by another entity) or that the customer has already obtained from the entity or from other transactions or events.

A customer can benefit from a good or service if the good or service could be used, consumed, sold for an amount that is greater than scrap value or otherwise held in a way that generates economic benefits.

Sometimes, a customer can benefit from a good or service only with other readily available resources. A readily available resource is a good or service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained from the entity (including goods or services that the entity will have already transferred to the customer under the contract) or from other transactions or events. Various factors may provide evidence that the customer can benefit from a good or service either on its own or in conjunction with other readily available resources.

For e.g, the fact that the entity regularly sells a good or service on its own is an indicator that the good or service is capable of being distinct.

6.1.2 Separately identifiable from other promises in the contract

Factors that indicate that an entity's promise to transfer a good or service to a customer is separately identifiable include, but are not limited to, the following:

6.1.2.1 Significant integration service

It indicates that two or more promises to transfer goods or services are not separately identifiable from other goods or services in the contract if the entity provides significant integration services. Stated differently, the entity is using the goods or services as inputs to produce the combined output called for in the contract.

6.1.2.2 Significant modification or customization

It indicates that two or more promises to transfer goods or services are not separately identifiable from other goods or services in the contract if one or more of the goods or services significantly modifies or customizes other promised goods or services in the contract.

In some industries, such as the software industry, the notion of inseparable risks is more clearly illustrated by assessing whether one good or service significantly modifies or customizes another good or service in the contract. In this case, the goods or services are inputs to create a combined output—a customized product.

6.1.2.3 Highly interdependent or highly interrelated

It indicates that two or more promises to transfer goods or services are not separately identifiable from other goods or services in the contract if the goods or services are highly interdependent or highly interrelated.

Sometimes it may be unclear whether the entity provides an integration service or whether the goods or services are significantly modified or customized; yet the individual goods or services are not separately identifiable from other goods or services because they are highly dependent on, or highly interrelated with, other promised goods or services in the contract.

The principle in evaluating whether promises are “distinct within the context of the contract” is to consider the level of integration, interrelation, or interdependence among promises to transfer goods or services. As a result, the entity must evaluate whether two or more promised goods or services significantly affect the other and are therefore highly interdependent or highly interrelated with other promised goods or services in the contract. An entity does not simply evaluate whether one item depends on another. There must be a two-way dependency. In other words, instead of concluding that an undelivered item would never be obtained by a customer absent the delivered item in the contract, the entity would consider whether the undelivered item and the delivered item each significantly affect the other and therefore are highly interdependent or highly interrelated.

Illustration 7

A construction services company enters into a contract with a customer to build a water purification plant. The company is responsible for all aspects of the plant including overall project management, engineering and design services, site preparation, physical construction of the plant, procurement of pumps and equipment for measuring and testing flow volumes and water quality, and the integration of all components.

Determine whether the company has a single or multiple performance obligations under the contract?

Solution

Determining whether a good or service represents a performance obligation on its own or is required to be aggregated with other goods or services can have a significant impact on the timing of revenue recognition. In order to determine how many performance obligations are present in the contract, the company applies the guidance above. While the customer may be able to benefit from each promised good or service on its own (or together with other readily available resources), they do not appear to be separately identifiable within the context of the contract. That is, the promised goods and services are subject to significant integration, and as a result will be treated as a single performance obligation.

This is consistent with a view that the customer is primarily interested in acquiring a single asset (a water purification plant) rather than a collection of related components and services.

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Illustration 8

An entity provides broadband services to its customers along with voice call service.

Customer buys modem from the entity. However, customer can also get the connection from the entity and modem from any other vendor. The installation activity requires limited effort and the cost involved is almost insignificant. It has various plans where it provides either broadband services or voice call services or both.

Are the performance obligations under the contract distinct?

Solution

Entity promises to customer to provide

- Broadband Service
- Voice Call services
- Modem

Entity's promise to provide goods and services is distinct if

- customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer, and
- entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract

For broadband and voice call services -

- Broadband and voice services are separately identifiable from other promises as company has various plans to provide the two services separately. These two services are not dependant or interrelated. Also the customer can benefit on its own from the services received.

For sale of modem -

- Customer can either buy product from entity or third party. No significant customisation or modification is required for selling product.

Based on the evaluation we can say that there are three separate performance obligation: -

- Broadband Service
- Voice Call services
- Modem

*****

Illustration 9

An entity enters into a contract to build a power plant for a customer. The entity will be responsible for the overall management of the project including services to be provided like engineering, site *clearance, foundation, procurement, construction of the structure, piping and wiring, installation of equipment and finishing.*

Determine how many performance obligations does the entity have?

Solution

Based on the discussion above it needs to be determined that the promised goods and services are capable of being distinct as per the principles of Ind AS 115. That is, whether the customer can benefit from the goods and services either on their own or together with other readily available resources. This is evidenced by the fact that the entity, or competitors of the entity, regularly sells many of these goods and services separately to other customers. In addition, the customer could generate economic benefit from the individual goods and services by using, consuming, selling or holding those goods or services.

However, the goods and services are not distinct within the context of the contract. That is, the entity's promise to transfer individual goods and services in the contract are not separately identifiable from other promises in the contract. This is evidenced by the fact that the entity provides a significant service of putting together the various inputs or goods and services into the power plant or the output for which the customer has contracted.

Since both the criteria has not met, the goods and services are not distinct. The entity accounts for all of the goods and services in the contract as a single performance obligation.

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B. Promise to transfer a series of distinct goods or services:

There might be cases, where distinct goods or services are provided continuously over a period of time. For e.g. security services, or bookkeeping services. This will be considered as single performance obligation, if the consumption of those services by the customers is symmetrical.

A series of distinct goods or services has the same pattern of transfer to the customer if both of the following criteria are met:

(a) each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria to be a performance obligation satisfied over time; and

(b) the same method would be used to measure the entity's progress towards complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

Illustration 10

Could the series requirement apply to hotel management services where day to day activities vary, involve employee management, procurement, accounting, etc?

Solution

The series guidance requires each distinct good or service to be "substantially the same."

Management should evaluate this requirement based on the nature of its promise to customer. For example, a promise to provide hotel management services for a specified contract term may meet the series criteria. This is because the entity is providing the same service of "hotel management" each period, even though some on underlying activities may vary each day. The underlying activities for e.g. reservation services, property maintenance services are activities to fulfil the hotel management service rather than separate promises. The distinct service within the series is each time increment of performing the service.

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6.2 Multiple Element Arrangements/ Goods and services that are not distinct

Once an entity determines whether the goods and services would be distinct based on their individual characteristics, the entity then has to consider if the manner in which the goods and services have been bundled in an arrangement would require the entity to account for two or more goods or services as one performance obligation. This determination would be required regardless of whether or not those goods and services were determined to be distinct on their own.

If the good or services are not considered as distinct, those goods or services are combined with other goods or services under the contract till the time the entity identifies a bundle of distinct goods or services.

This combination would result in accounting of multiple goods or services in the contract as a single performance obligation. This could also result in an entity combining a good or service that is not considered distinct with another good or service that, on its own, would have met the criteria to be considered distinct. An entity may end up accounting for all the goods or services promised in a contract as a single performance obligation if the entire bundle of promised goods and services is the only distinct performance obligation identified.

It is important to note that the assessment of whether a good or service is distinct must consider the specific contract with a customer. That is, an entity cannot assume that a particular good or service is distinct (or not distinct) in all instances. The manner in which promised goods and services are bundled within a contract can affect the conclusion of whether a good or service is distinct. Entities may treat the same goods and services differently, depending on how those goods and services are bundled within a contract.

Illustration 11

Entity A, a specialty construction firm, enters into a contract with Entity B to design and construct a multi-level shopping centre with a customer car parking facility located in sub-levels underneath the shopping centre. Entity B solicited bids from multiple firms on both phases of the project — design and construction.

The design and construction of the shopping centre and parking facility involves multiple goods and *services from architectural consultation and engineering through procurement and installation of all of the materials. Several of these goods and services could be considered separate performance obligations because Entity A frequently sells the services, such as architectural consulting and engineering services, as well as standalone construction services based on third party design, separately. Entity A may require to continually alter the design of the shopping centre and parking facility during construction as well as continually assess the propriety of the materials initially selected for the project.*

Determine how many performance obligations does the entity A have?

Solution

Entity A analyses that it will be required to continually alter the design of the shopping centre and parking facility during construction as well as continually assess the propriety of the materials initially selected for the project. Therefore, the design and construction phases are highly dependent on one another (i.e., the two phases are highly interrelated). Entity A also determines that significant customisation and modification of the design and construction services is required in order to fulfil the performance obligation under the contract. As such, Entity A concludes that the design and construction services will be bundled and accounted for as one performance obligation.

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Illustration 12

An entity, a software developer, enters into a contract with a customer to transfer a software license, perform an installation service and provide unspecified software updates and technical support (online and telephone) for a two-year period. The entity sells the license, installation service and technical support separately. The installation service includes changing the web screen for each type of user (for example, marketing, inventory management and information technology). The installation service is routinely performed by other entities and does not significantly modify the software. The software remains functional without the updates and the technical support.

Determine how many performance obligations does the entity have?

Solution

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct. The entity observes that the software is delivered before the other goods and services and remains functional without the updates and the technical support. Thus, the entity concludes that the customer can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available.

The entity also considers the factors of Ind AS 115 and determines that the promise to transfer each good and service to the customer is separately identifiable from each of the other promises. In particular, the entity observes that the installation service does not significantly modify or customise the software itself and, as such, the software and the installation service are separate outputs promised by the entity instead of inputs used to produce a combined output.

On the basis of this assessment, the entity identifies four performance obligations in the contract for the following goods or services:

- The software license
- An installation service
- Software updates
- Technical support

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Illustration 13 : Significant customisation

The promised goods and services are the same as in the above Illustration, except that the contract specifies that, as part of the installation service, the software is to be substantially customised to add significant new functionality to enable the software to interface with other customised software applications used by the customer. The customised installation service can be provided by other entities.

Determine how many performance obligations does the entity have?

Solution

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct. The entity observes that the terms of the contract result in a promise to provide a significant service of integrating the licensed software into the existing software system by performing a customised installation service as specified in the contract. In other words, the entity is using the license and the customised installation service as inputs to produce the combined output (i.e. a functional and integrated software system) specified in the contract. In addition, the software is significantly modified and customised by the service. Although the customised installation service can be provided by other entities, the entity determines that within the context of the contract, the promise to transfer the license is not separately identifiable from the customised installation service and, therefore, the criterion on the basis of the factors is not met. Thus, the software license and the customised installation service are not distinct.

The entity concludes that the software updates and technical support are distinct from the other promises in the contract. This is because the customer can benefit from the updates and technical support either on their own or together with the other goods and services that are readily available and because the promise to transfer the software updates and the technical support to the customer are separately identifiable from each of the other promises.

On the basis of this assessment, the entity identifies three performance obligations in the contract for the following goods or services:

a) customised installation service (that includes the software license);

b) software updates; and

c) technical support.

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6.3 Customer options for additional goods or services

Retail and consumer products entities frequently give certain customers the option to purchase additional goods or services. These options come in many forms, including sales incentives (e.g., coupons with a limited distribution, competitor price matching programs aimed at only some customers, gift cards issued by a retailer as a promotion) and customer award credits (e.g., loyalty or reward programs).

The standard states that when an entity grants a customer the option to acquire additional goods or services, that option is only a separate performance obligation if it provides a material right to the customer. The right is material if it results in a discount that the customer would not receive without entering into the contract (e.g., a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market).

If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services and the entity recognises revenue when those future goods or services are transferred or when the option expires.

If the discounted price in the option reflects the stand-alone selling price (separate from any existing relationship or contract), the entity is deemed to have made a marketing offer rather than having granted a material right.

In such cases, the entity has made a marketing offer that it shall account for in accordance with this Standard only when the customer exercises the option to purchase the additional goods or services.

This standard requires that an entity to allocate the transaction price to performance obligations on a relative stand-alone selling price basis. If the stand-alone selling price for a customer's option to acquire additional goods or services is not directly observable, an entity shall estimate it. That estimate shall reflect the discount that the customer would obtain when exercising the option, adjusted for both of the following:

(a) any discount that the customer could receive without exercising the option; and

(b) the likelihood that the option will be exercised.

Illustration 14

An entity enters into a contract for the sale of Product A for ₹ 1,000. As part of the contract, the entity gives the customer a 40% discount voucher for any future purchases up to ₹ 1,000 in the next 30 days. The entity intends to offer a 10% discount on all sales during the next 30 days as part of a seasonal promotion. The 10% discount cannot be used in addition to the 40% discount voucher.

The entity believes there is 80% likelihood that a customer will redeem the voucher and on an average, a customer will purchase ₹ 500 of additional products.

Determine how many performance obligations does the entity have and their stand-alone selling price and allocated transaction price?

Solution

Since all customers will receive a 10% discount on purchases during the next 30 days, the only additional discount that provides the customer with a material right is the incremental discount of 30% on the products purchased. The entity accounts for the promise to provide the incremental discount as a separate performance obligation in the contract for the sale of Product A.

The entity believes there is 80% likelihood that a customer will redeem the voucher and on an average, a customer will purchase ₹ 500 of additional products. Consequently, the entity's estimated stand-alone selling price of the discount voucher is ₹ 120 (₹ 500 average purchase price of additional products x 30% incremental discount x 80% likelihood of exercising the option). The stand-alone selling prices of Product A and the discount voucher and the resulting allocation of the ₹ 1,000 transaction price are as follows:

Performance obligations	Stand-alone selling price
Product A	₹ 1000
Discount voucher	₹ 120
Total	₹ 1120

Performance obligations		Allocated transaction price (to nearest ₹10)
Product A	(₹ 1000 ÷ ₹ 1120 × ₹ 1000)	₹ 890
Discount voucher	(₹ 120 ÷ ₹ 1120 × ₹ 1000)	₹ 110
Total		₹ 1000

The entity allocates ₹ 890 to Product A and recognises revenue for Product A when control transfers. The entity allocates ₹ 110 to the discount voucher and recognises revenue for the voucher when the customer redeems it for goods or services or when it expires.

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6.4 Long term arrangements

Entities frequently enter into arrangements to provide services on a long-term basis, such as maintenance services to be provided over a long period of time.

For example, should a three-year maintenance agreement be considered a single performance obligation representing the entire contractual period, or should it be broken into smaller periods (daily, monthly or yearly)? It may be appropriate to treat a three-year services contract as three separate one-year performance obligations, if the contract can be renewed or cancelled by either party at discrete points in time (that is, at the end of each service year).

The entity would separately account for its rights and obligations for each period in which the contract cannot be cancelled by either party.

In long-term service agreements when the consideration is fixed, the accounting generally will not change regardless of whether a single performance obligation or multiple performance obligations are identified.

Illustration 15

A cable company provides television services for a fixed rate fee of ₹ 800 per month for a period of 3 years. Cable services is satisfied overtime because customer consumes and receives benefit from services as it is provided i.e. customer generally benefits each day that they have access to cable service.

Determine how many performance obligations does the cable company have?

Solution

Cable company determines that each increment of its services e.g. day or month, is a distinct performance obligation because customer benefits from that period of services on its own. Additionally, each increment of service is separately identifiable from those preceding and following it i.e. one service period does not significantly affect, modify or customise another. Therefore, it can be concluded that its contract with customer is a single performance obligation to provide three years of cable service because each of the distinct increments of service is satisfied over time. Also, cable company uses the same measure of progress to recognise revenue on its cable television service regardless of the contract's time period.

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6.5 Consignment Arrangements

A consignment agreement is an agreement between a consignee and consignor for the storage, transfer, sale or resale and use of the goods. The consignee may take goods from the consignment stock for use or resale subject to payment to the consignor agreeably to the terms bargained in the consignment agreement. Entities frequently deliver inventory on a consignment basis to other parties (e.g., distributor, dealer).

The following indicators have been provided to evaluate whether the arrangement is a consignment arrangement:

(a) the product is controlled by the entity until a specified event occurs, such as the sale of the product to a customer of the dealer or until a specified period expires;

(b) the entity is able to require the return of the product or transfer the product to a third party (such as another dealer); and

(c) the dealer does not have an unconditional obligation to pay for the product (although it might be required to pay a deposit).

Entities entering into a consignment arrangement must determine the nature of the performance obligation (i.e., whether the obligation is to transfer the inventory to the consignee or to transfer the inventory to the end customer). This determination is based on whether control of the inventory has passed to the consignee upon delivery. In case of consignment arrangement, a consignor will not relinquish control of consignment inventory until the inventory is sold to the consumer or on the expiry of an agreed period. Consignees does not have an obligation to pay, until the goods are sold to the ultimate or end consumer. As a result, revenue generally would not be recognised for consignment arrangements when the goods are delivered to the consignee because control has not yet transferred. Revenue is recognized when the entity has transferred control of the goods to the consignor or the end consumer. A consignment sale differs from a sale with a right of return. The customer has control of the goods in a sale with right of return and can decide whether to put the goods back to the seller. In case of consignment sales, the consignee does not have the control over the goods.

Illustration 16

Manufacturer M enters into a 60-day consignment contract to ship 1,000 dresses to Retailer A's stores. Retailer A is obligated to pay Manufacturer M ₹ 20 per dress when the dress is sold to an end customer.

During the consignment period, Manufacturer M has the contractual right to require Retailer A to either return the dresses or transfer them to another retailer. Manufacturer M is also required to accept the return of the inventory. State when the control is transferred.

Solution

Manufacturer M determines that control has not been transferred to Retailer A on delivery, for the following reasons:

(a) Retailer A does not have an unconditional obligation to pay for the dresses until they have been sold to an end customer;

(b) Manufacturer M is able to require that the dresses be transferred to another retailer at any time before Retailer A sells them to an end customer; and

(c) Manufacturer M is able to require the return of the dresses or transfer them to another retailer.

Manufacturer M determines that control of the dresses transfers when they are sold to an end customer i.e. when Retailer A has an unconditional obligation to pay Manufacturer M and can no longer return or otherwise transfer the dresses.

Manufacturer M recognises revenue as the dresses are sold to the end customer.

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6.6 Principal vs agent consideration

Some contracts result in an entity's customer receiving goods or services from another entity that is not a direct party to the contract with the customer. The standard states that when other parties are involved in providing goods or services to an entity's customer, the entity must determine whether its performance obligation is to provide the good or service itself (i.e., the entity is a principal) or to arrange for another party to provide the good or service (i.e., the entity is an agent). The determination of whether the entity is acting as a principal or an agent affects the amount of revenue the entity recognises. That is,

- when the entity is the principal in the arrangement, the revenue recognised is the gross amount to which the entity expects to be entitled.
- when the entity is acting as an agent, the revenue recognised is the net amount i.e. the amount, entity is entitled to retain in return for its services under the contract. The entity's fee or commission may be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

A principal's performance obligations in an arrangement differ from an agent's performance obligations. For example, if an entity obtains control of the goods or services of another party before it transfers those goods or services to the customer, the entity's performance obligation may be to provide the goods or services itself. Hence, the entity likely is acting as a principal and would recognise revenue in the gross amount to which it is entitled. An entity that obtains legal title of a product only momentarily before legal title is transferred to the customer is not necessarily acting as a principal. In contrast, an agent facilitates the sale of goods or services to the customer in exchange for a fee or commission and generally does not control the goods or services for any length of time. Therefore, the agent's performance obligation is to arrange for another party to provide the goods or services to the customer. Since the identification of the principal in a contract is not always clear, Ind AS 115 provides indicators that a performance obligation involves an agency relationship.

Indicators that an entity is a principal (and therefore controls the good or service before it is provided to a customer) include the following:

(a) the entity is primarily responsible for fulfilling the contract. This typically includes responsibility for the acceptability of the specified good or service;

(b) the entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (for example, if the customer has a right of return).

(c) the entity has discretion in establishing prices for the goods or services.

After an entity identifies its promise and determines whether it is the principal or the agent, the entity recognises revenue when it satisfies that performance obligation. In some contracts in which the entity is the agent, control of the goods or services promised by the agent might transfer before the customer receives the goods or services from the principal.

For example, an entity might satisfy its promise to provide customers with loyalty points when those points are transferred to the customer if:

(a) The entity's promise is to provide loyalty points to customers when the customer purchases goods or services from the entity

(b) The points entitle the customers to future discounted purchases with another party (i.e., the points represent a material right to a future discount)

(c) The entity determines that it is an agent (i.e., its promise is to arrange for the customers to be provided with points) and the entity does not control those points before they are transferred to the customer.

In contrast, if the points entitle the customers to future goods or services to be provided by the entity, the entity may conclude it is not an agent. This is because the entity's promise is to provide those future goods or services.

Therefore, the entity controls both the points and the future goods or services before they are transferred to the customer. In these cases, the entity's performance obligation may only be satisfied when the future goods or services are provided.

In other cases, the points may entitle customers to choose between future goods or services provided by either the entity or another party. In this situation, the nature of the entity's performance obligation may not be known until the customer makes its choice. That is, until the customer has chosen the goods or services to be provided (and, therefore, whether the entity or the third party will provide those goods or services), the entity is obliged to stand ready to deliver goods or services. Therefore, the entity may not satisfy its performance obligation until it either delivers the goods or services or is no longer obliged to stand ready. If the customer subsequently chooses the goods or services from another party, the entity would need to consider whether it was acting as an agent. If so, it would recognise revenue, but only for the fee or commission that the entity receives in return for providing the services to the customer and the third party.

Following example illustrates the application of the principal versus agent application guidance:

Illustration 17

An entity negotiates with major airlines to purchase tickets at reduced rates compared with the price of tickets sold directly by the airlines to the public. The entity agrees to buy a specific number of tickets and will pay for those tickets even if it is not able to resell them. The reduced rate paid by the entity for each ticket purchased is negotiated and agreed in advance. The entity determines the prices at which the airline tickets will be sold to its customers. The entity sells the tickets and collects the consideration from customers when the tickets are purchased; therefore, there is no credit risk.

The entity also assists the customers in resolving complaints with the service provided by airlines.

However, each airline is responsible for fulfilling obligations associated with the ticket, including remedies to a customer for dissatisfaction with the service.

Determine whether the entity is a principal or an agent.

Solution

To determine whether the entity's performance obligation is to provide the specified goods or services itself (i.e. the entity is a principal) or to arrange for another party to provide those goods or services (i.e. the entity is an agent), the entity considers the nature of its promise. The entity determines that its promise is to provide the customer with a ticket, which provides the right to fly on the specified flight or another flight if the specified flight is changed or cancelled. The entity considers the following indicators for assessment as principal or agent under the contract with the customers:

(a) the entity is primarily responsible for fulfilling the contract, which is providing the right to fly. However, the entity is not responsible for providing the flight itself, which will be provided by the airline.

(b) the entity has inventory risk for the tickets because they are purchased before they are sold to the entity's customers and the entity is exposed to any loss as a result of not being able to sell the tickets for more than the entity's cost.

(c) the entity has discretion in setting the sales prices for tickets to its customers.

The entity concludes that its promise is to provide a ticket (i.e. a right to fly) to the customer. On the basis of the indicators, the entity concludes that it controls the ticket before it is transferred to the customer. Thus, the entity concludes that it is a principal in the transaction and recognises revenue in the gross amount of consideration to which it is entitled in exchange for the tickets transferred.

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6.7 Non-refundable upfront fees

In some contracts, an entity charges the customer a non-refundable upfront fee. Examples include joining fees in health club membership, activation fees for telecom services, setup fees in certain service contracts and initial fees or joining fees in some supply contracts with the distributors or customers.

To identify performance obligations in such contracts, an entity shall assess whether the fee relates to an activity that the entity is required to undertake at the inception of the contract, or that activity does not result in the transfer of a promised good or service to the customer.

In many cases, even though a non-refundable upfront fee relates to an activity that the entity is required to undertake at or near contract inception to fulfil the contract, that activity does not result in the transfer of a promised good or service to the customer. Instead the upfront fee is an advance payment for future goods and services and, therefore, would be recognised as revenue when those future goods and services are provided.

If the non-refundable upfront fee relates to a goods or service, the entity shall evaluate whether to account for the goods or services as a separate performance obligation. An entity may charge a non-refundable as a part of compensation of costs incurred in setting up a contract (or other administrative tasks). If those setup activities do not satisfy performance obligation, the entity shall disregard those activities (and related costs) when measuring progress. That is because the costs of setup activities do not depict transfer of services to customer.

Illustration 18

Customer buy a new data connection from the telecom entity. It pays one-time registration and activation fees at the time of purchase of new connection. The customer will be charged based on the usage of the data services of the connection on monthly basis.

Are the performance obligations under the contract distinct?

Solution

By selling a new connection, the entity promises to supply data services to customer. Customer will not be able to benefit from just buying a data card and data services from third party. The activity of registering and activating connection is not a service to customer and therefore does not represent satisfaction of performance obligation.

Entity's obligation is to provide data service and hence activation is not a separate performance obligation.

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7. STEP 3: DETERMINING THE TRANSACTION PRICE

Measurement (Ind AS 115.46)

"When (or as) a performance obligation is satisfied, an entity shall recognise as revenue the amount of the transaction price (which excludes estimates of variable consideration that are constrained in accordance with paragraphs 56–58) that is allocated to that performance obligation."

After identifying the contract in Step 1 and the performance obligations in Step 2, an entity next applies Step 3 to **determine the transaction price** of the contract. The objective of Step 3 is to predict the total amount of consideration to which the entity will be entitled from the contract.

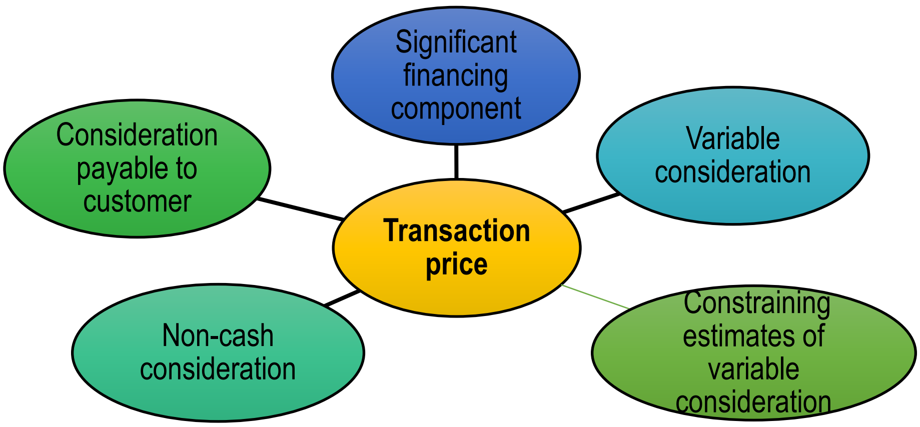
What is transaction price? (Ind AS 115.47)

"The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes)."

The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both. Further, an entity shall consider the terms of the contract and its customary business practices to determine the transaction price.

For the purpose of determining the transaction price, an entity shall assume that the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be cancelled, renewed or modified.

The nature, timing and amount of consideration promised by a customer affect the estimate of the transaction price. When determining the transaction price, an entity shall consider the effects of all of the following:



7.1 Variable consideration

What is variable consideration? (Ind AS 115.50)

"If the consideration promised in a contract includes a variable amount, an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer."

Examples of variable consideration (Ind AS 115.51)

"An amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, or other similar items. The promised consideration can also vary if an entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event. For example, an amount of consideration would be variable if either a product was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone."

Variable consideration may be fixed in amount, but the entity's right to receive that consideration is contingent on a future outcome. For example, the amount of a performance bonus might be fixed, but because the entity is not entitled to that bonus until a performance target is met, the outcome is uncertain and therefore the amount is considered variable.

As per Ind AS 115.52, the variability relating to the consideration promised by a customer **may be explicitly stated** in the contract. In addition to the terms of the contract, the promised consideration is variable if either of the following circumstances exists:

(a) the customer has a **valid expectation arising from an entity's customary business practices**, published policies or specific statements that the entity will accept an amount of consideration that is less than the price stated in the contract. That is, it is expected that the entity will offer a price concession. Depending on the jurisdiction, industry or customer this offer may be referred to as a discount, rebate, refund or credit.

(b) other facts and circumstances indicate that the **entity's intention**, when entering into the contract with the customer, is to offer a price concession to the customer.

7.1.1 Penalties

As per Ind AS 115.51AA, penalties shall be accounted for as per the substance of the contract. Where the penalty is inherent in determination of transaction price, it shall form part of variable consideration.

For example, where an entity agrees to transfer control of a good or service in a contact with customer at the end of 30 days for ₹ 100,000 and if it exceeds 30 days, the entity is entitled to receive only ₹ 95,000, the reduction of ₹ 5,000 shall be regarded as variable consideration. In other cases, the transaction price shall be considered as fixed.

7.1.2 Estimating the amount of variable consideration

As per Ind AS 115.53, an entity shall estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

(a) **The expected value -** the expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.

(b) **The most likely amount -** the most likely amount is the single most likely amount in a range of possible consideration amounts (ie the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

An entity shall apply one method consistently throughout the contract when estimating the effect of an uncertainty on an amount of variable consideration to which the entity will be entitled. An entity shall consider all the information that is reasonably available to the entity and shall identify a reasonable number of possible consideration amounts.

Illustration 19 – Estimating variable consideration

XYZ Limited enters into a contract with a customer to build a sophisticated machinery. The promise to transfer the asset is a performance obligation that is satisfied over time. The promised consideration is ₹ 2.5 crore, but that amount will be reduced or increased depending on the timing of completion of the asset. Specifically, for each day after 31st March, 20X1 that the asset is incomplete, the promised consideration is reduced by ₹ 1 lakh. For each day before 31st March, 20X1 that the asset is complete, the promised consideration increases by ₹ 1 lakh.

In addition, upon completion of the asset, a third party will inspect the asset and assign a rating based on metrics that are defined in the contract. If the asset receives a specified rating, the entity will be entitled to an incentive bonus of ₹ 15 lakh.

Determine the transaction price.

Solution

In determining the transaction price, the entity prepares a separate estimate for each element of variable consideration to which the entity will be entitled using the estimation methods described in paragraph 53 of Ind AS 115:

a) the entity decides to use the expected value method to estimate the variable consideration associated with the daily penalty or incentive (i.e. ₹ 2.5 crore, plus or minus ₹ 1 lakh per day). This is because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled.

b) the entity decides to use the most likely amount to estimate the variable consideration associated with the incentive bonus. This is because there are only two possible outcomes (₹ 15 lakh or ₹ Nil) and it is the method that the entity expects to better predict the amount of consideration to which it will be entitled.

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The entity considers the requirements in paragraphs 56–58 of Ind AS 115 (discussed below) on constraining estimates of variable consideration to determine whether the XYZ Limited should include some or all of its estimate of variable consideration in the transaction price.

Illustration 20 – Estimating variable consideration

AST Limited enters into a contract with a customer to build a manufacturing facility. The entity determines that the contract contains one performance obligation satisfied over time.

Construction is scheduled to be completed by the end of the 36th month for an agreed-upon price of ₹ 25 crore.

The entity has the opportunity to earn a performance bonus for early completion as follows:

- *15 percent bonus of the contract price if completed by the 30th month (25% likelihood)*
- *10 percent bonus if completed by the 32nd month (40% likelihood)*
- *5 percent bonus if completed by the 34th month (15% likelihood)*

In addition to the potential performance bonus for early completion, AST Limited is entitled to a quality bonus of ₹ 2 crore if a health and safety inspector assigns the facility a gold star rating as defined by the agency in the terms of the contract. AST Limited concludes that it is 60% likely that it will receive the quality bonus.

Determine the transaction price.

Solution

In determining the transaction price, AST Limited separately estimates variable consideration for each element of variability ie the early completion bonus and the quality bonus.

AST Limited decides to use the expected value method to estimate the variable consideration associated with the early completion bonus because there is a range of possible outcomes and the entity has experience with a large number of similar contracts that provide a reasonable basis to predict future outcomes. Therefore, the entity expects this method to best predict the amount of variable consideration associated with the early completion bonus. AST's best estimate of the early completion bonus is ₹ 2.13 crore, calculated as shown in the following table:

Bonus %	Amount of bonus (₹ in crore)	Probability	Probability-weighted amount (₹ in crore)
15%	3.75	25%	0.9375
10%	2.50	40%	1.00
5%	1.25	15%	0.1875
0%	-	20%	-
			2.125

AST Limited decides to use the most likely amount to estimate the variable consideration associated with the potential quality bonus because there are only two possible outcomes (₹ 2 crore or ₹ Nil) and this method would best predict the amount of consideration associated with the quality bonus. AST Limited believes the most likely amount of the quality bonus is ₹ 2 crore.

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As per para 54 of Ind AS 115, an entity shall apply one method consistently throughout the contract when estimating the effect of an uncertainty on an amount of variable consideration to which the entity will be entitled. In addition, an entity shall consider all the information (historical, current and forecast) that is reasonably available to the entity and shall identify a reasonable number of possible consideration amounts. The information that an entity uses to estimate the amount of variable consideration would typically be similar to the information that the entity's management uses during the bid-and-proposal process and in establishing prices for promised goods or services.

7.1.3 Refund liabilities

As per para 55 of Ind AS 115, an entity shall recognise a refund liability if the entity receives consideration from a customer and expects to refund some or all of that consideration to the customer. A refund liability is measured at the amount of consideration received (or receivable) for which the entity does not expect to be entitled (i.e. amounts not included in the transaction price). The refund liability (and corresponding change in the transaction price and, therefore, the *contract liability*) shall be updated at the end of each reporting period for changes in circumstances.

7.1.4 Constraining estimates of variable consideration

As per para 56 of Ind AS 115, an entity shall include in the transaction price some or all of an amount of variable consideration estimated in accordance with paragraph 53 only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

As per para 57 of Ind AS 115, in assessing whether it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur once the uncertainty related to the variable consideration is subsequently resolved, an entity shall consider both the likelihood and the magnitude of the revenue reversal. Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, any of the following:

(a) the amount of consideration is highly susceptible to factors outside the entity's influence. Those factors may include volatility in a market, the judgement or actions of third parties, weather conditions and a high risk of obsolescence of the promised good or service.

(b) the uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

(c) the entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.

(d) the entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

(e) the contract has a large number and broad range of possible consideration amounts.

7.1.5 Reassessment of variable consideration

At the end of each reporting period, an entity shall update the estimated transaction price (including updating its assessment of whether an estimate of variable consideration is constrained) to represent faithfully the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period. The entity shall account for changes in the transaction price in accordance with paragraphs 87–90 of Ind AS 115.

Illustration 21– Volume discount incentive

HT Limited enters into a contract with a customer on 1st April, 20X1 to sell Product X for ₹ 1,000 per unit. If the customer purchases more than 100 units of Product A in a financial year, the contract specifies that the price per unit is retrospectively reduced to ₹ 900 per unit. Consequently, the consideration in the contract is variable.

For the first quarter ended 30th June, 20X1, the entity sells 10 units of Product A to the customer. The entity estimates that the customer's purchases will not exceed the 100 unit threshold required for the volume discount in the financial year. HT Limited determines that it has significant experience with this product and with the purchasing pattern of the customer. Thus, HT Limited concludes that it is highly probable that a significant reversal in the cumulative amount of revenue recognised (i.e. ₹ 1,000 per unit) will not occur when the uncertainty is resolved (i.e. when the total amount of purchases is known).

Further, in May, 20X1, the customer acquires another company and in the second quarter ended 30th September, 20X1 the entity sells an additional 50 units of Product A to the customer. In the light of the new fact, the entity estimates that the customer's purchases will exceed the 100 unit threshold for the financial year and therefore it will be required to retrospectively reduce the price per unit to ₹ 900.

Determine the amount of revenue to be recognise by HT Ltd. for the quarter ended 30th June, 20X1 and 30th September, 20X1.

Solution

The entity recognises revenue of ₹ 10,000 (10 units × ₹ 1,000 per unit) for the quarter ended 30th June, 20X1.

HT Limited recognises revenue of ₹ 44,000 for the quarter ended 30th September, 20X1. That amount is calculated from ₹ 45,000 for the sale of 500 units (50 units x ₹ 900 per unit) less the change in transaction price of ₹ 1,000 (10 units x ₹ 100 price reduction) for the reduction of revenue relating to units sold for the quarter ended 30th June, 20X1.

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Illustration 22 – Measurement of variable consideration

An entity has a fixed fee contract for ₹ 1 million to develop a product that meets specified performance criteria. Estimated cost to complete the contract is ₹ 950,000. The entity will transfer control of the *product over five years, and the entity uses the cost-to-cost input method to measure progress on the contract. An incentive award is available if the product meets the following weight criteria:*

Weight (kg)	***Award % of fixed fee***	***Incentive fee***
951 or greater	*0%*	*—*
701–950	*10%*	*₹ 100,000*
700 or less	*25%*	*₹ 250,000*

The entity has extensive experience creating products that meet the specific performance criteria. Based on its experience, the entity has identified five engineering alternatives that will achieve the 10 percent incentive and two that will achieve the 25 percent incentive. In this case, the entity determined that it has 95 percent confidence that it will achieve the 10 percent incentive and 20 percent confidence that it will achieve the 25 percent incentive.

Based on this analysis, the entity believes 10 percent to be the most likely amount when estimating the transaction price. Therefore, the entity includes only the 10 percent award in the transaction price when calculating revenue because the entity has concluded it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved due to its 95 percent confidence in achieving the 10 percent award.

The entity reassesses its production status quarterly to determine whether it is on track to meet the criteria for the incentive award. At the end of the year four, it becomes apparent that this contract will fully achieve the weight-based criterion. Therefore, the entity revises its estimate of variable consideration to include the entire 25 percent incentive fee in the year four because, at this point, it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when including the entire variable consideration in the transaction price.

Evaluate the impact of changes in variable consideration when cost incurred is as follows:

Year	*₹*
1	*50,000*
2	*1,75,000*
3	*4,00,000*
4	*2,75,000*
5	*50,000*

Solution

[Note: For simplification purposes, the table calculates revenue for the year independently based on costs incurred during the year divided by total expected costs, with the assumption that total expected costs do not change.]

Fixed consideration	A	1,000,000				
Estimated costs to complete*	B	950,000				
		Year 1	Year 2	Year 3	Year 4	Year 5
Total estimated variable consideration	C	100,000	100,000	100,000	250,000	250,000
Fixed revenue	D=A x H/B	52,632	184,211	421,053	289,474	52,632
Variable revenue	E=C x H/B	5,263	18,421	42,105	72,368	13,158
Cumulative revenue adjustment	F (see below)	—	—	—	99,370	—
Total revenue	G=D+E+F	57,895	202,632	463,158	461,212	65,790
Costs	H	50,000	175,000	400,000	275,000	50,000
Operating profit	I=G–H	7,895	27,632	63,158	186,212	15,790
Margin (rounded off)	J=I/G	14%	14%	14%	40%	24%

* For simplicity, it is assumed there is no change to the estimated costs to complete throughout the contract period.

* In practice, under the cost-to-cost measure of progress, total revenue for each period is determined by multiplying the total transaction price (fixed and variable) by the ratio of cumulative cost incurred to total estimated costs to complete, less revenue recognized to date.

Calculation of cumulative catch-up adjustment:			
Updated variable consideration	L		250,000
Percent complete in Year 4: (rounded off)	M=N/O		95%
Cumulative costs through Year 4	N	900,000	
Estimated costs to complete	O	950,000	
Cumulative variable revenue through Year 4:	P		138,130
Cumulative catch-up adjustment	F=L x M–P		99,370

*****

Illustration 23 – Management fees subject to the constraint

On 1st April, 20X1, an entity enters into a contract with a client to provide asset management services for five years. The entity receives a two per cent quarterly management fee based on the client's assets under management at the end of each quarter. At 31st March, 20X2, the client's assets under *management are ₹ 100 crore. In addition, the entity receives a performance-based incentive fee of 20 per cent of the fund's return in excess of the return of an observable market index over the five-year period. Consequently, both the management fee and the performance fee in the contract are variable consideration.*

Analyse the revenue to be recognised on 31st March, 20X2.

Solution

The entity accounts for the services as a single performance obligation because it is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress—that is, a time-based measure of progress).

The entity observes that the promised consideration is dependent on the market and thus is highly susceptible to factors outside the entity's influence. In addition, the incentive fee has a large number and a broad range of possible consideration amounts. The entity also observes that although it has experience with similar contracts, that experience is of little predictive value in determining the future performance of the market. Therefore, at contract inception, the entity cannot conclude that it is highly probable that a significant reversal in the cumulative amount of revenue recognised would not occur if the entity included its estimate of the management fee or the incentive fee in the transaction price.

At each reporting date, the entity updates its estimate of the transaction price. Consequently, at the end of each quarter, the entity concludes that it can include in the transaction price the actual amount of the quarterly management fee because the uncertainty is resolved. However, the entity concludes that it cannot include its estimate of the incentive fee in the transaction price at those dates. This is because there has not been a change in its assessment from contract inception—the variability of the fee based on the market index indicates that the entity cannot conclude that it is highly probable that a significant reversal in the cumulative amount of revenue recognised would not occur if the entity included its estimate of the incentive fee in the transaction price.

At 31st March, 20X2, the client's assets under management are ₹ 100 crore. Therefore, the resulting quarterly management fee and the transaction price is ₹ 2 crore.

At the end of each quarter, the entity allocates the quarterly management fee to the distinct services provided during the quarter. This is because the fee relates specifically to the entity's efforts to transfer the services for that quarter, which are distinct from the services provided in other quarters.

Consequently, the entity recognises ₹ 2 crore as revenue for the quarter ended 31st March, 20X2.

*****

7.1.6 Sale with a right of return

In some contracts, an entity transfers control of a product to a customer (refer Step 5) and also grants the customer the right to return the product for various reasons (such as dissatisfaction with the product) and receive any combination of the following:

(a) a full or partial refund of any consideration paid;

(b) a credit that can be applied against amounts owed, or that will be owed, to the entity; and

(c) another product in exchange.

Ind AS 115.B20AA clarifies that in some contracts, an entity transfers control of a product to a customer with an unconditional right of return. In such cases, the recognition of revenue shall be as per the substance of the arrangement. Where the substance is that of a consignment sale, the entity shall account for such a contract as per the provisions of Ind AS 115's application guidance related to consignment sales (refer paragraph B77 and B78 of Application Guidance to Ind AS 115). In other cases, the accounting for contracts with customers shall be as per provisions laid out below.

To account for the transfer of products with a right of return (and for some services that are provided subject to a refund), an entity shall recognise all of the following:

(a) revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (therefore, revenue would not be recognised for the products expected to be returned);

(b) a refund liability; and

(c) an asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.

An entity's promise to stand ready to accept a returned product during the return period shall not be accounted for as a performance obligation in addition to the obligation to provide a refund.

An entity shall apply the requirements in paragraphs 47–72 (including the requirements for constraining estimates of variable consideration in paragraphs 56–58) to determine the amount of consideration to which the entity expects to be entitled (i.e. excluding the products expected to be returned). For any amounts received (or receivable) for which an entity does not expect to be entitled, the entity shall not recognise revenue when it transfers products to customers but shall recognise those amounts received (or receivable) as a refund liability. Subsequently, at the end of each reporting period, the entity shall update its assessment of amounts for which it expects to be entitled in exchange for the transferred products and make a corresponding change to the transaction price and, therefore, in the amount of revenue recognised.

An entity shall update the measurement of the refund liability at the end of each reporting period for changes in expectations about the amount of refunds. An entity shall recognise corresponding adjustments as revenue (or reductions of revenue).

An asset recognised for an entity's right to recover products from a customer on settling a refund liability shall initially be measured by reference to the former carrying amount of the product (for example, inventory) less any expected costs to recover those products (including potential decreases in the value to the entity of returned products). At the end of each reporting period, an entity shall update the measurement of the asset arising from changes in expectations about products to be returned. An entity shall present the asset separately from the refund liability.

Exchanges by customers of one product for another of the same type, quality, condition and price (for example, one colour or size for another) are not considered returns for the purposes of applying this Standard.

Contracts in which a customer may return a defective product in exchange for a functioning product shall be evaluated in accordance with the guidance on warranties given below.

Illustration 24 – Right of return

An entity enters into 1,000 contracts with customers. Each contract includes the sale of one product for ₹ 50 (1,000 total products × ₹ 50 = ₹ 50,000 total consideration). Cash is received when control of a product transfers. The entity's customary business practice is to allow a customer to return any unused product within 30 days and receive a full refund. The entity's cost of each product is ₹ 30.

The entity applies the requirements in Ind AS 115 to the portfolio of 1,000 contracts because it reasonably expects that, in accordance with paragraph 4, the effects on the financial statements from applying these requirements 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. To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 53(a) of Ind AS 115) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates that 970 products will not be returned.

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

Determine the amount of revenue, refund liability and the asset to be recognised by the entity for the said contracts.

Solution

The entity also considers the requirements in paragraphs 56–58 of Ind AS 115 on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration of ₹ 48,500 (₹ 50 × 970 products not expected to be returned) can be included in the transaction price. The entity considers the factors in paragraph 57 of Ind AS 115 and 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. ₹ 48,500) will not occur as the uncertainty is resolved (i.e. over the return period).

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

Upon transfer of control of the 1,000 products, the entity does not recognise revenue for the 30 products 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 ₹ 48,500 (₹ 50 × 970 products not expected to be returned);

(b) a refund liability of ₹ 1,500 (₹ 50 refund × 30 products expected to be returned); and

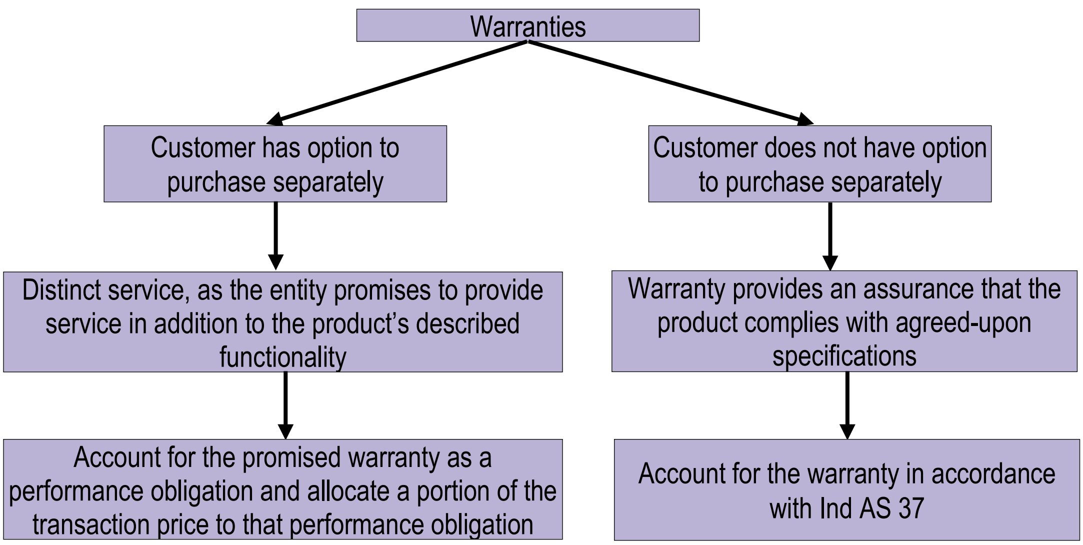
(c) an asset of ₹ 900 (₹ 30 × 30 products for its right to recover products from customers on settling the refund liability).

*****

7.1.7 Warranties

It is common for an entity to provide (in accordance with the contract, the law or the entity's customary business practices) a warranty in connection with the sale of a product (whether a good or service). The nature of a warranty can vary significantly across industries and contracts. Some warranties provide a customer with **assurance** that the related product will function as the parties intended because it complies with agreed-upon specifications. Other warranties provide the customer with a **service** in addition to the assurance that the product complies with agreed-upon specifications.

The flowchart below summarises the accounting treatment for the two broad types of warranties:



As per Ind AS 115.B31, in assessing whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, an entity shall consider factors such as:

(a) Whether the warranty is required by law—if the entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation because such requirements typically exist to protect customers from the risk of purchasing defective products.

(b) The length of the warranty coverage period—the longer the coverage period, the more likely it is that the promised warranty is a performance obligation because it is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications.

(c) The nature of the tasks that the entity promises to perform—if it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (for example, a return shipping service for a defective product), then those tasks likely do not give rise to a performance obligation.

As per Ind AS 115.B32, if an entity promises both an assurance-type warranty and a service-type warranty but cannot reasonably account for them separately, the entity shall account for both of the warranties together as a single performance obligation.

As per Ind AS 115.B33, a law that requires an entity to pay compensation if its products cause harm or damage does not give rise to a performance obligation. For example, a manufacturer might sell products in a jurisdiction in which the law holds the manufacturer liable for any damages (for example, to personal property) that might be caused by a consumer using a product for its intended purpose. Similarly, an entity's promise to indemnify the customer for liabilities and damages arising from claims of patent, copyright, trademark or other infringement by the entity's products does not give rise to a performance obligation. The entity shall account for such obligations in accordance with Ind AS 37.

7.1.8 Sales-based or usage-based royalties

As per Ind AS 115.B63, notwithstanding the requirements of Ind AS 115 related to constraining estimate of variable consideration (discussed above), an entity shall recognise revenue for a sales-based or usage-based royalty promised in exchange for a licence of intellectual property only when (or as) the later of the following events occurs:

(a) the subsequent sale or usage occurs; and

(b) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

As per Ind AS 115.B63A, the accounting requirements for a sales-based or usage-based royalty discussed above apply when the royalty relates only to a licence of intellectual property or when a licence of intellectual property is the predominant item to which the royalty relates (for example, the licence of intellectual property may be the predominant item to which the royalty relates when the entity has a reasonable expectation that the customer would ascribe significantly more value to the licence than to the other goods or services to which the royalty relates).

As per Ind AS 115.B63B, when the requirement in paragraph B63A is met, revenue from a sales-based or usage-based royalty shall be recognised wholly in accordance with paragraph B63. When the requirement in paragraph B63A is not met, the requirements on variable consideration discussed earlier apply to the sales-based or usage-based royalty.

7.2 Significant financing component

In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. Either party may benefit from financing—that is, the customer may pay before the entity performs its obligation (a customer loan to the entity) or the customer may pay after the entity performs its obligation (a loan by the entity to the customer). In those circumstances, the contract contains a significant financing component.

A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.

The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognise revenue at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer (ie the cash selling price).

An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including **both** of the following:

(a) the difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services; and

(b) the combined effect of both of the following:

   (i) the expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services; and

   (ii) the prevailing interest rates in the relevant market.

To meet the objective stated above, when adjusting the promised amount of consideration for a significant financing component, an entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. That rate would reflect the credit characteristics of the party receiving financing in the contract, as well as any collateral or security provided by the customer or the entity, including assets transferred in the contract.

An entity may be able to determine that rate by identifying the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer. After contract inception, an entity shall not update the discount rate for changes in interest rates or other circumstances (such as a change in the assessment of the customer's credit risk).

An entity considers the significance of a financing component only at a contract level and not whether the financing is material at a portfolio level. In other words, if the combined effects for a portfolio of similar contracts were material to the entity as a whole, but if the effects of the financing component were not material to the individual contract, such financing component shall not be considered significant and shall not be separately accounted for.

Illustration 25 – Financing component: significant or insignificant?

A commercial airplane component supplier enters into a contract with a customer for promised consideration of ₹ 7,000,000. Based on an evaluation of the facts and circumstances, the supplier concluded that ₹ 140,000 represented a insignificant financing component because of an advance payment received in excess of a year before the transfer of control of the product.

State whether company needs to make any adjustment in determining the transaction price.

What if the advance payment was larger and received further in advance, such that the entity concluded that ₹ 1,400,000 represented the financing component based on an analysis of the facts and circumstances.

Solution

The entity may conclude that ₹ 140,000, or 2 percent of the contract price, is not significant, and the entity may not need to adjust the consideration promised in determining the transaction price.

However, when the advance payment was larger and received further in advance, such that the entity may conclude that ₹ 1,400,000 represents the financing component based on an analysis of the facts and circumstances. In such a case, the entity may conclude that ₹ 1,400,000, or 20 percent of the contract price, is significant, and the entity should adjust the consideration promised in determining the transaction price.

Note: In this illustration, the entity's conclusion that 2 percent of the transaction price was not significant and 20 percent was significant is a judgment based on the entity's facts and circumstances. An entity may reach a different conclusion based on its facts and circumstances.

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Illustration 26 – Accounting for significant financing component

NKT Limited sells a product to a customer for ₹ 121,000 that is payable 24 months after delivery. The customer obtains control of the product at contract inception. The contract permits the customer to return the product within 90 days. The product is new and the entity has no relevant historical evidence of product returns or other available market evidence.

The cash selling price of the product is ₹ 100,000 which represents the amount that the customer would pay upon delivery for the same product sold under otherwise identical terms and conditions *as at contract inception. The entity's cost of the product is ₹ 80,000. The contract includes an implicit interest rate of 10 per cent (i.e. the interest rate that over 24 months discounts the promised consideration of ₹ 121,000 to the cash selling price of ₹ 100,000). Analyse the above transaction with respect to its financing component.*

Solution

The contract includes a significant financing component. This is evident from the difference between the amount of promised consideration of ₹ 121,000 and the cash selling price of ₹ 100,000 at the date that the goods are transferred to the customer.

The contract includes an implicit interest rate of 10 per cent (i.e. the interest rate that over 24 months discounts the promised consideration of ₹ 121,000 to the cash selling price of ₹ 100,000). The entity evaluates the rate and concludes that it is commensurate with the rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception.

Until the entity receives the cash payment from the customer, interest revenue would be recognised in accordance with Ind AS 109. In determining the effective interest rate in accordance with Ind AS 109, the entity would consider the remaining contractual term.

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Illustration 27 – Determining the discount rate

VT Limited enters into a contract with a customer to sell equipment. Control of the equipment transfers to the customer when the contract is signed. The price stated in the contract is ₹ 1 crore plus a 10% contractual rate of interest, payable in 60 monthly instalments of ₹ 212,470.

Determine the discounting rate and the transaction price when

Case A—Contractual discount rate reflects the rate in a separate financing transaction

Case B—Contractual discount rate does not reflect the rate in a separate financing transaction ie 14%.

Solution

Case A—Contractual discount rate reflects the rate in a separate financing transaction

In evaluating the discount rate in the contract that contains a significant financing component, VT Limited observes that the 10% contractual rate of interest reflects the rate that would be used in a separate financing transaction between the entity and its customer at contract inception (i.e. the contractual rate of interest of 10% reflects the credit characteristics of the customer).

The market terms of the financing mean that the cash selling price of the equipment is ₹ 1 crore. This amount is recognised as revenue and as a loan receivable when control of the equipment transfers to the customer. The entity accounts for the receivable in accordance with Ind AS 109.

Case B—Contractual discount rate does not reflect the rate in a separate financing transaction

In evaluating the discount rate in the contract that contains a significant financing component, the entity observes that the 10% contractual rate of interest is significantly lower than the 14% interest rate that would be used in a separate financing transaction between the entity and its customer at contract inception (i.e. the contractual rate of interest of 10% does not reflect the credit characteristics of the customer). This suggests that the cash selling price is less than ₹ 1 crore.

VT Limited determines the transaction price by adjusting the promised amount of consideration to reflect the contractual payments using the 14% interest rate that reflects the credit characteristics of the customer. Consequently, the entity determines that the transaction price is ₹ 9,131,346 (60 monthly payments of ₹ 212,470 discounted at 14%). The entity recognises revenue and a loan receivable for that amount. The entity accounts for the loan receivable in accordance with Ind AS 109.

*****

Illustration 28– Advance payment and assessment of discount rate

ST Limited enters into a contract with a customer to sell an asset. Control of the asset will transfer to the customer in two years (i.e. the performance obligation will be satisfied at a point in time). The contract includes two alternative payment options:

1) Payment of ₹ 5,000 in two years when the customer obtains control of the asset or

2) Payment of ₹ 4,000 when the contract is signed. The customer elects to pay ₹ 4,000 when the contract is signed.

ST Limited concludes that the contract contains a significant financing component because of the length of time between when the customer pays for the asset and when the entity transfers the asset to the customer, as well as the prevailing interest rates in the market.

The interest rate implicit in the transaction is 11.8 per cent, which is the interest rate necessary to make the two alternative payment options economically equivalent. However, the entity determines that, the rate that should be used in adjusting the promised consideration is 6%, which is the entity's incremental borrowing rate.

Pass journal entries showing how the entity would account for the significant financing component

Solution

Journal Entries showing accounting for the significant financing component:

(a) Recognise a contract liability for the ₹ 4,000 payment received at contract inception:

Cash	Dr.	₹ 4,000	
To Contract liability			₹ 4,000

(b) During the two years from contract inception until the transfer of the asset, the entity adjusts the promised amount of consideration and accretes the contract liability by recognising interest on ₹ 4,000 at 6% for two years:

Interest expense	Dr.	₹ 494*	
To Contract liability			₹ 494

* ₹ 494 = ₹ 4,000 contract liability × (6% interest per year for two years).

(c) Recognise revenue for the transfer of the asset:

Contract liability	Dr.	₹ 4,494	
To Revenue			₹ 4,494

*****

Ind AS 115.62 contains an overriding provision, which specifies that, a contract with a customer would not have a significant financing component if any of the following factors exist:

(a) the **customer paid for the goods or services in advance** and the timing of the transfer of those goods or services is at the discretion of the customer. For example, consider a prepaid card for mobile phone services, wherein the customer has the discretion to avail mobile services within a certain band of time.

(b) a **substantial amount of the consideration promised by the customer is variable** and the amount or **timing** of that consideration varies on the basis of the occurrence or non-occurrence of a future event that is **not substantially within the control of the customer or the entity** (for example, if the consideration is a sales-based royalty).

(c) the difference between the promised consideration and the cash selling price of the good or service arises for **reasons other than the provision of finance to either the customer or the entity**, and the difference between those amounts is proportional to the reason for the difference. For example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract.

Illustration 29– Withheld payments on a long-term contract

ABC Limited enters into a contract for the construction of a power plant that includes scheduled milestone payments for the performance by ABC Limited throughout the contract term of three years. The performance obligation will be satisfied over time and the milestone payments are scheduled to coincide with the expected performance by ABC Limited. The contract provides that a specified percentage of each milestone payment is to be withheld as retention money by the customer throughout the arrangement and paid to the entity only when the building is complete.

Analyse whether the contract contains any financing component.

Solution

ABC Limited concludes that the contract does not include a significant financing component since the milestone payments coincide with its performance and the contract requires amounts to be retained for reasons other than the provision of finance. The withholding of a specified percentage of each milestone payment is intended to protect the customer from the contractor failing to adequately complete its obligations under the contract.

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Illustration 30– Advance payment

XYZ Limited, a personal computer (PC) manufacturer, enters into a contract with a customer to provide global PC support and repair coverage for three years along with its PC. The customer purchases this support service at the time of buying the product. Consideration for the service is an additional ₹ 3,000. Customers electing to buy this service must pay for it upfront (i.e. a monthly payment option is not available).

Analyse whether there is any significant financing component in the contract or not.

Solution

To determine whether there is a significant financing component in the contract, the entity considers the nature of the service being offered and the purpose of the payment terms. The entity charges a single upfront amount, not with the primary purpose of obtaining financing from the customer but, instead, to maximise profitability, taking into consideration the risks associated with providing the service. Specifically, if customers could pay monthly, they would be less likely to renew and the population of customers that continue to use the support service in the later years may become smaller and less diverse over time (i.e. customers that choose to renew historically are those that make greater use of the service, thereby increasing the entity's costs). In addition, customers tend to use services more if they pay monthly rather than making an upfront payment. Finally, the entity would incur higher administration costs such as the costs related to administering renewals and collection of monthly payments.

In assessing whether or not the contract contains a significant financing component, XYZ Limited determines that the payment terms were structured primarily for reasons other than the provision of finance to the entity. XYZ Limited charges a single upfront amount for the services because other payment terms (such as a monthly payment plan) would affect the nature of the risks it assumes to provide the service and may make it uneconomical to provide the service. As a result of its analysis, XYZ Limited concludes that there is not a significant financing component.

*****

Illustration 31– Advance payment

A computer hardware vendor enters into a three-year arrangement with a customer to provide support services. For customers with low credit ratings, the vendor requires the customer to pay for the entire arrangement in advance of the provision of service. Other customers pay over time.

Analyse whether there is any significant financing component in the contract or not.

Solution

Due to this customer's credit rating, the customer pays in advance for the three-year term. Because there is no difference between the amount of promised consideration and the cash selling price (that is, the customer does not receive a discount for paying in advance), the vendor requires payment in advance only to protect against customer non-payment, and no other factors exist to suggest the arrangement contains a financing, the vendor concludes this contract does not provide the customer or the entity with a significant benefit of financing.

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Illustration 32 – Sales based royalty

A software vendor enters into a contract with a customer to provide a license solely in exchange for a sales-based royalty.

Analyse whether there is any significant financing component in the contract or not.

Solution

Although the payment will be made in arrears, because the total consideration varies based on the occurrence or non-occurrence of a future event that is not within the control of the customer or the entity, the software vendor concludes the contract does not provide the customer or the entity with a significant benefit of financing.

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Illustration 33 – Payment in arrears

An EPC contractor enters into a two-year contract to develop customized machine for a customer. The contractor concludes that the goods and services in this contract constitute a single performance obligation.

Based on the terms of the contract, the contractor determines that it transfers control over time, and recognizes revenue based on an input method best reflecting the transfer of control to the customer. The customer agrees to provide the contractor monthly progress payments, with the final 25 percent payment (holdback payment) due upon contract completion. As a result of the holdback payment, there is a gap between when control transfers and when consideration is received, creating a financing component.

Analyse whether there is any significant financing component in the contract or not.

Solution

There is no difference between the amount of promised consideration and the cash selling price (that is, the customer did not pay a premium for paying a portion of the consideration in arrears). The payment terms included a holdback payment only to ensure successful completion of the project, and no other factors exist to suggest the arrangement contains a financing. Hence, the contractor concludes this contract does not provide the customer or the contractor with a significant benefit of financing.

*****

Illustration 34– Payment in arrears

Company Z is a developer and manufacturer of defence systems that is primarily a Tier-II supplier of parts and integrated systems to original equipment manufacturers (OEMs) in the commercial markets. Company Z enters into a contract with Company X for the development and delivery of 5,000 highly technical, specialized missiles for use in one of Company X's platforms.

As a part of the contract, Company X has agreed to pay Company Z for their cost plus an award fee up to ₹ 100 crore. The consideration will be paid by the customer related to costs incurred near the time Company Z incurs such costs. However, the ₹ 100 crore award fee is awarded upon successful completion of the development and test fire of a missile to occur in 16 months from the time the contract is executed.

The contract specifies Company Z will earn up to ₹ 100 crore based on Company X's assessment of Company Z's ability to develop and manufacture a missile that achieves multiple factors, including final weight, velocity, and accuracy.

Partial award fees may be awarded based on a pre-determined scale based on their success.

Assume Company Z has assessed the contract under Ind AS 115 and determined the award fee represents variable consideration. Based on their assessment, Company Z has estimated a total of ₹ 80 crore in the transaction price related to the variable consideration pursuant to guidance within Ind AS 115. Further, the entity has concluded it should recognize revenue over time for a single performance obligation using a cost-to-cost input method.

Analyse whether there is any significant financing component in the contract or not.

Solution

Company Z will transfer control over time beginning shortly after the contract is executed, but will not receive the cash consideration related to the award fee component from Company X for more than one year in the future. Hence, Company Z should assess whether the award fee represents a significant financing component.

The intention of the parties in negotiating the award fee due upon completion of the test fire, and based on the results of that test fire, was to provide incentive to Company Z to produce high functioning missiles that achieved successful scoring from Company X. Therefore, it was determined the contract does not contain a significant financing component, and Company Z should not adjust the transaction price.

As per Ind AS 115.63, as a practical expedient, an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between:

(a) when the entity transfers a promised good or service to a customer and

(b) when the customer pays for that good or service

will be one year or less.

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Illustration 35– Applying practical expedient

Company H enters into a two-year contract to develop customized software for Company C. Company H concludes that the goods and services in this contract constitute a single performance obligation.

Based on the terms of the contract, Company H determines that it transfers control over time, and recognizes revenue based on an input method best reflecting the transfer of control to Company C.

Company C agrees to provide Company H monthly progress payments. Based on the expectation of the timing of costs to be incurred, Company H concludes that progress payments are being made such that the timing between the transfer of control and payment is never expected to exceed one year.

Analyse whether there is any significant financing component in the contract or not.

Solution

Company H concludes it will not need to further assess whether a significant financing component is present and does not adjust the promised consideration in determining the transaction price, as they are applying the practical expedient under Ind AS 115.

As per Ind AS 115.65, an entity shall present the effects of financing (interest revenue or interest expense) separately from revenue from contracts with customers in the statement of profit and loss. Interest revenue or interest expense is recognised only to the extent that a contract asset (or receivable) or a contract liability is recognised in accounting for a contract with a customer.

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7.3 Non-cash consideration

Sometimes a customer promises to pay for a good or service in a form other than cash, such as shares of common stock or other equity instruments, advertising, or equipment.

To determine the transaction price for contracts in which a customer promises consideration in a form other than cash, an entity shall:

- In the first instance, measure the non-cash consideration (or promise of non-cash consideration) at fair value.
- And, if it cannot reasonably estimate the fair value of the non-cash consideration, it shall measure the consideration indirectly by reference to the stand-alone selling price of the goods or services promised to the customer (or class of customer) in exchange for the consideration.

7.3.1 Subsequent measurement of non-cash consideration

- If the fair value of the non-cash consideration varies after contract inception because of its form (for example, a change in the price of a share to which an entity is entitled to receive from a customer), the entity does not adjust the transaction price for any changes in the fair value of the consideration.

Illustration 36– Entitlement to non-cash consideration

An entity enters into a contract with a customer to provide a weekly service for one year. The contract is signed on 1st April, 20X1 and work begins immediately. The entity concludes that the service is a single performance obligation. This is because the entity is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress — that is, a time-based measure of progress).

In exchange for the service, the customer promises its 100 equity shares per week of service (a total of 5,200 shares for the contract). The terms in the contract require that the shares must be paid upon the successful completion of each week of service.

How should the entity decide the transaction price?

Solution

The entity measures its progress towards complete satisfaction of the performance obligation as each week of service is complete. To determine the transaction price (and the amount of revenue to be recognised), the entity has to measure the fair value of 100 shares that are received upon completion of each weekly service. The entity shall not reflect any subsequent changes in the fair value of the shares received (or receivable) in revenue.

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- If the fair value of the non-cash consideration promised by a customer varies for reasons other than only the form of the consideration (for example, the fair value could vary because of the entity's performance), the entity is required to apply the guidance on variable consideration and the constraint when determining the transaction price.

Illustration 37– Fair value of non-cash consideration varies for reasons other than the form of the consideration

RT Limited enters into a contract to build an office building for AT Limited over an 18-month period. AT Limited agrees to pay the construction entity ₹ 350 crore for the project. RT Limited will receive a bonus of 10 lakh equity shares of AT Limited if it completes construction of the office building within one year. Assume a fair value of ₹ 100 per share at contract inception.

Determine the transaction price.

Solution

The ultimate value of any shares the entity might receive could change for two reasons:

1) the entity earns or does not earn the shares and

2) the fair value per share may change during the contract term.

When determining the transaction price, the entity would reflect changes in the number of shares to be earned. However, the entity would not reflect changes in the fair value per share. Said another way, the share price of ₹ 100 is used to value the potential bonus throughout the life of the contract.

As a result, if the entity earns the bonus, its revenue would be ₹ 350 crore plus 10 lakh equity shares at ₹ 100 per share for total consideration of ₹ 360 crore.

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7.3.2 Customer-provided goods or services

If a customer contributes goods or services (for example, materials, equipment or labour) to facilitate an entity's fulfilment of the contract, the entity shall assess whether it obtains control of those contributed goods or services. If so, the entity shall account for the contributed goods or services as non-cash consideration received from the customer.

Illustration 38– Customer-provided goods or services

MS Limited is a manufacturer of cars. It has a supplier of steering systems – SK Limited. MS Limited places an order of 10,000 steering systems on SK Limited. It also agrees to pay ₹ 25,000 per steering system and contributes tooling to be used in SK's production process.

The tooling has a fair value of ₹ 2 crore at contract inception. SK Limited determines that each steering system represents a single performance obligation and that control of the steering system transfers to MS Limited upon delivery.

SK Limited may use the tooling for other projects and determines that it obtains control of the tooling.

Determine the transaction price?

Solution

As a result, at contract inception, SK Limited includes the fair value of the tooling in the transaction price at contract inception, which it determines to be ₹ 27 crore (₹ 25 crore for the steering systems and ₹ 2 crore for the tooling).

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7.4 Consideration payable to a customer

The rationale behind the accounting provisions related to "consideration payable to a customer" is that an entity should not overstate its revenue by amounts given to customers in a contract that it will receive back through the purchase of its goods or services.

Consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer). Consideration payable to a customer also includes credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer).

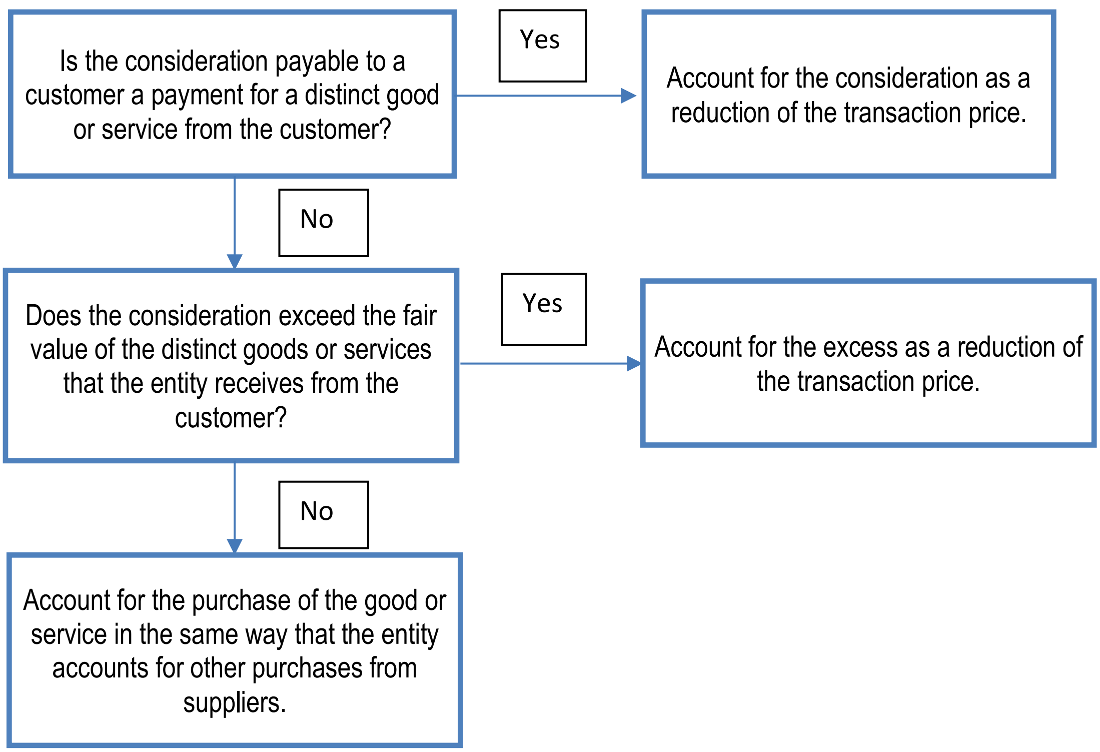
The key to appropriately accounting for consideration payable to a customer is determining whether the payment is made in exchange for a distinct good or service:

- When the entity receives a good or service from the customer, it applies the guidance in Step 2 in identifying its performance obligations to determine if that good or service is distinct.

  When an entity concludes that the consideration paid to a customer is in exchange for a distinct good or service, it accounts for the distinct good or service as it would any other purchase from a supplier, as long as the consideration paid does not exceed the fair value of the goods or services received. When the consideration exceeds the fair value of the distinct goods or services received, any excess is accounted for as a reduction in the transaction price. If the entity cannot reasonably estimate the fair value of the good or service received from the customer, it shall account for all of the consideration payable to the customer as a reduction of the transaction price.

- If, on the other hand, the entity concludes that the consideration paid to the customer is not in exchange for a distinct good or service, the entity would reduce the transaction price by the amount it pays or owes the customer.

The below diagram summarises the guidance above:



If the consideration payable to a customer includes a variable amount, an entity shall estimate the transaction price (including assessing whether the estimate of variable consideration is constrained) in accordance with accounting guidance on "variable consideration" discussed earlier.

As per Ind AS 115.72, if consideration payable to a customer is accounted for as a reduction of the transaction price, an entity shall recognise the reduction of revenue when (or as) the later of either of the following events occurs:

(a) the entity recognises revenue for the transfer of the related goods or services to the customer; and

(b) the entity pays or promises to pay the consideration (even if the payment is conditional on a future event). That promise might be implied by the entity's customary business practices.

Illustration 39– Consideration payable to a customer

An entity that manufactures consumer goods enters into a one-year contract to sell goods to a customer that is a large global chain of retail stores. The customer commits to buy at least ₹ 15 crore of products during the year. The contract also requires the entity to make a non-refundable payment of ₹ 1.5 crore to the customer at the inception of the contract. The ₹ 1.5 crore payment will compensate the customer for the changes it needs to make to its shelving to accommodate the entity's products. The entity does not obtain control of any rights to the customer's shelves.

Determine the transaction price.

Solution

The entity considers the requirements in paragraphs 70 – 72 of Ind AS 115 and concludes that the payment to the customer is not in exchange for a distinct good or service that transfers to the entity. This is because the entity does not obtain control of any rights to the customer's shelves. Consequently, the entity determines that, in accordance with paragraph 70 of Ind AS 115, the ₹ 1.5 crore payment is a reduction of the transaction price.

The entity applies the requirements in paragraph 72 of Ind AS 115 and concludes that the consideration payable is accounted for as a reduction in the transaction price when the entity recognises revenue for the transfer of the goods. Consequently, as the entity transfers goods to the customer, the entity reduces the transaction price for each good by 10 per cent [(₹ 1.5 crore ÷ ₹ 15 crore) x 100]. Therefore, in the first month in which the entity transfers goods to the customer, the entity recognises revenue of ₹ 1.125 crore (₹ 1.25 crore invoiced amount less ₹ 0.125 crore of consideration payable to the customer).

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8. STEP 4: ALLOCATING THE TRANSACTION PRICE TO PERFORMANCE OBLIGATIONS

Allocation objective- While allocating the transaction price, the objective of the entity should be to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

To meet the above allocation objective, an entity shall allocate the transaction price to each performance obligation identified in the contract on a relative stand-alone selling price basis as per the standard, except for allocating discounts and for allocating consideration that includes variable amounts.

Simply put, there are two exceptions to the general allocation guidance:

- allocating discounts, and
- allocating variable consideration

Under these exceptions, an entity allocates a disproportionate amount of the transaction price to specific performance obligations based on evidence that suggests the discount or variable consideration relates to those specific performance obligations.

8.1 Determining stand-alone selling price

The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer.

As per Ind AS 115, the best evidence of a stand-alone selling price is - **the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers**.

An entity shall determine the stand-alone selling price at contract inception of the distinct good or service underlying each performance obligation in the contract and allocate the transaction price in proportion to those stand-alone selling prices, to allocate the transaction price to each performance obligation on a relative stand-alone selling price basis.

A contractually stated price or a list price for a good or service **may be (but shall not be presumed to be)** the stand-alone selling price of that good or service.

If a stand-alone selling price is not directly observable, for example, the entity does not sell the good or service separately, an entity shall estimate the stand-alone selling price at an amount that would result in the allocation of the transaction price meeting the allocation objective in paragraph 73 above. When estimating a stand-alone selling price, an entity shall consider all information (including market conditions, entity-specific factors and information about the customer or class of customer) that is reasonably available to the entity. In doing so, an entity shall maximise the use of observable inputs and apply estimation methods consistently in similar circumstances.

Evaluating the evidence related to estimating a stand-alone selling price may require significant judgment.

An entity should establish policies and procedures for estimating stand-alone selling price and apply those policies and procedures consistently to similar performance obligations. As a best practice, an entity should document its evaluation of the market conditions and entity-specific factors considered in estimating each stand-alone selling price, including factors that it considers to be irrelevant and the reasons why.

Suitable methods for estimating the stand-alone selling price of a good or service include, but are not limited to, the following:

(a) **Adjusted market assessment approach**—an entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. That approach might also include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.

(b) **Expected cost plus a margin approach**—an entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service. When determining which costs to include in the selling price analysis, an entity should develop and consistently apply a methodology that considers direct and indirect costs, as well as other relevant costs considered in its normal pricing practices, such as research and development costs. Determining the margin to use when applying a cost-plus-a-margin approach requires significant judgment, particularly when the entity is not planning to separately sell a product or service. Furthermore, using an expected cost-plus-margin approach may not be appropriate in many circumstances, such as when direct fulfillment costs are not easily identifiable or when costs are not a significant input in setting the price for the goods or services.

(c) **Residual approach**—an entity may estimate the stand-alone selling price by reference to (1) the total transaction price, less (2) the sum of the observable stand-alone selling prices of other goods or services promised in the contract.

However, an entity may use a residual approach to estimate the stand-alone selling price of a good or service only if one of the following criteria is met:

(i) the entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (ie the selling price is highly variable because a representative stand-alone selling price is not discernible from past transactions or other observable evidence); or

(ii) the entity has not yet established a price for that good or service and the good or service has not previously been sold on a stand-alone basis (ie the selling price is uncertain).

An entity shall allocate the discount before using the residual approach to estimate the stand-alone selling price of a good or service where the discount is allocated entirely to one or more performance obligations in the contract.

A combination of methods may need to be used to estimate the stand-alone selling prices of the goods or services promised in the contract if two or more of those goods or services have highly variable or uncertain stand-alone selling prices. For example, an entity may use a residual approach to estimate the aggregate stand-alone selling price for those promised goods or services with highly variable or uncertain stand-alone selling prices and then use another method to estimate the stand-alone selling prices of the individual goods or services relative to that estimated aggregate stand-alone selling price determined by the residual approach. When an entity uses a combination of methods to estimate the stand-alone selling price of each promised good or service in the contract, the entity shall evaluate whether allocating the transaction price at those estimated stand-alone selling prices would be consistent with the allocation objective in paragraph 73 and the requirements for estimating stand-alone selling prices.

8.1.1 Allocation of a discount

A customer receives a discount for purchasing a bundle of goods or services if the sum of the stand-alone selling prices of those promised goods or services in the contract exceeds the promised consideration in a contract.

Unless an entity has observable evidence (if (c) criteria below are fulfilled) that the entire discount relates to only one or more, but not all, performance obligations in a contract, the entity shall allocate a discount proportionately to all performance obligations in the contract. The proportionate allocation of the discount in those circumstances is a consequence of the entity allocating the transaction price to each performance obligation on the basis of the relative stand-alone selling prices of the underlying distinct goods or services (as discussed earlier).

When to allocate discount to 'less than all' performance obligations?

As per Ind AS 115.82, an entity shall allocate a discount entirely to one or more, but not all, performance obligations in the contract **if all of the following criteria are met**:

(a) the entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a stand-alone basis;

(b) the entity also regularly sells on a stand-alone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the stand-alone selling prices of the goods or services in each bundle; and

(c) the discount attributable to each bundle of goods or services described in (b) above is substantially the same as the discount in the contract and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.

Note: – As a **first step**, always allocate the discount entirely to one or more performance obligations in the contract (if applicable), and then as a **second step**, use the residual approach to estimate the stand-alone selling price of a good or service.

Illustration 40– Allocation methodology

An entity enters into a contract with a customer to sell Products A, B and C in exchange for ₹ 10,000. The entity will satisfy the performance obligations for each of the products at different points in time. The entity regularly sells Product A separately and therefore the stand-alone selling price is directly observable. The stand-alone selling prices of Products B and C are not directly observable.

Because the stand-alone selling prices for Products B and C are not directly observable, the entity must estimate them. To estimate the stand-alone selling prices, the entity uses the adjusted market assessment approach for Product B and the expected cost plus a margin approach for Product C. In making those estimates, the entity maximises the use of observable inputs.

The entity estimates the stand-alone selling prices as follows:

Product	***Stand-alone selling price***	***Method***
	₹	
Product A	*5,000*	*Directly observable*
Product B	*2,500*	*Adjusted market assessment approach*
Product C	*7,500*	*Expected cost plus a margin approach*
Total	*15,000*	

Determine the transaction price allocated to each product.

Solution

The customer receives a discount for purchasing the bundle of goods because the sum of the stand-alone selling prices (₹ 15,000) exceeds the promised consideration (₹ 10,000). The entity considers that there is no observable evidence about the performance obligation to which the entire discount belongs. The discount is allocated proportionately across Products A, B and C. The discount, and therefore the transaction price, is allocated as follows:

Product	**Allocated transaction price (to nearest ₹100)**	
	₹	
Product A	3,300	(₹ 5,000 ÷ ₹ 15,000 × ₹ 10,000)
Product B	1,700	(₹ 2,500 ÷ ₹ 15,000 × ₹ 10,000)
Product C	5,000	(₹ 7,500 ÷ ₹ 15,000 × ₹ 10,000)
Total	10,000	

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Illustration 41– Allocating a discount

An entity regularly sells Products X, Y and Z individually, thereby establishing the following stand-alone selling prices:

Product	***Stand-alone selling price***
	₹
Product X	*50,000*
Product Y	*25,000*
Product Z	*45,000*
Total	*1,20,000*

In addition, the entity regularly sells Products Y and Z together for ₹ 50,000.

Case A—Allocating a discount to one or more performance obligations

The entity enters into a contract with a customer to sell Products X, Y and Z in exchange for ₹ 100,000. The entity will satisfy the performance obligations for each of the products at different points in time; or Product Y and Z at same point of time. Determine the allocation of transaction price to Product Y and Z.

Case B—Residual approach is appropriate

The entity enters into a contract with a customer to sell Products X, Y and Z as described in Case A. The contract also includes a promise to transfer Product Alpha. Total consideration in the contract is ₹ 130,000. The stand-alone selling price for Product Alpha is highly variable because the entity sells Product Alpha to different customers for a broad range of amounts (₹ 15,000 – ₹ 45,000). Determine the stand-alone selling price of Products, X, Y, Z and Alpha using the residual approach.

Case C—Residual approach is inappropriate

The same facts as in Case B apply to Case C except the transaction price is ₹ 1,05,000 instead of ₹ 130,000.

Solution

Case A—Allocating a discount to one or more performance obligations

The contract includes a discount of ₹ 20,000 on the overall transaction, which would be allocated proportionately to all three performance obligations when allocating the transaction price using the relative stand-alone selling price method.

However, because the entity regularly sells Products Y and Z together for ₹ 50,000 and Product X for ₹ 50,000, it has evidence that the entire discount should be allocated to the promises to transfer Products Y and Z in accordance with paragraph 82 of Ind AS 115.

If the entity transfers control of Products Y and Z at the same point in time, then the entity could, as a practical matter, account for the transfer of those products as a single performance obligation. That is, the entity could allocate ₹ 50,000 of the transaction price to the single performance obligation and recognise revenue of ₹ 50,000 when Products Y and Z simultaneously transfer to the customer.

If the contract requires the entity to transfer control of Products Y and Z at different points in time, then the allocated amount of ₹ 50,000 is individually allocated to the promises to transfer Product Y (stand-alone selling price of ₹ 25,000) and Product Z (stand-alone selling price of ₹ 45,000) as follows:

Product	Allocated transaction price	
	₹	
Product Y	17,857	(₹ 25,000 ÷ ₹ 70,000 total stand-alone selling price × ₹ 50,000)
Product Z	32,143	(₹ 45,000 ÷ ₹ 70,000 total stand-alone selling price × ₹ 50,000)
Total	50,000	

Case B—Residual approach is appropriate

Before estimating the stand-alone selling price of Product Alpha using the residual approach, the entity determines whether any discount should be allocated to the other performance obligations in the contract.

As in Case A, because the entity regularly sells Products Y and Z together for ₹ 50,000 and Product X for ₹ 50,000, it has observable evidence that ₹ 100,000 should be allocated to those three products and a ₹ 20,000 discount should be allocated to the promises to transfer Products Y and Z in accordance with paragraph 82 of Ind AS 115.

Using the residual approach, the entity estimates the stand-alone selling price of Product Alpha to be ₹ 30,000 as follows:

Product	Stand-alone selling price	Method
	₹	
Product X	50,000	Directly observable
Products Y and Z	50,000	Directly observable with discount
Product Alpha	30,000	Residual approach
Total	130,000	

The entity observes that the resulting ₹ 30,000 allocated to Product Alpha is within the range of its observable selling prices (₹ 15,000 – ₹ 45,000).

Case C—Residual approach is inappropriate

The same facts as in Case B apply to Case C except the transaction price is ₹ 105,000 instead of ₹ 130,000. Consequently, the application of the residual approach would result in a stand-alone selling price of ₹ 5,000 for Product Alpha (₹ 105,000 transaction price less ₹ 100,000 allocated to Products X, Y and Z).

The entity concludes that ₹ 5,000 would not faithfully depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying its performance obligation to transfer Product Alpha, because ₹ 5,000 does not approximate the stand-alone selling price of Product Alpha, which ranges from ₹ 15,000 – ₹ 45,000.

Consequently, the entity reviews its observable data, including sales and margin reports, to estimate the stand-alone selling price of Product Alpha using another suitable method. The entity allocates the transaction price of ₹ 1,05,000 to Products X, Y, Z and Alpha using the relative stand-alone selling prices of those products in accordance with paragraphs 73–80 of Ind AS 115.

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8.1.2 Allocation of variable consideration

Variable consideration may be attributable to (1) the entire contract or (2) a specific part of the contract, such as either of the following:

(a) one or more, but not all, performance obligations in the contract. For example, a contract may include two performance obligations: the construction of a building and the provision of services related to the ongoing maintenance of the property after construction. But a bonus for early completion may relate entirely to the construction of the building; or

(b) one or more, but not all, distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation (for example, the consideration promised for the second year of a two-year cleaning service contract will increase on the basis of movements in a specified inflation index).

How to allocate variable consideration?

In accordance with Ind AS 115.85, an entity shall allocate a variable amount (and subsequent changes to that amount) entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation **if both of the following criteria are met**:

- the terms of a variable payment <u>relate specifically to the entity's efforts</u> to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service); and
- allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is <u>consistent with the allocation objective in paragraph 73</u> when considering all of the performance obligations and payment terms in the contract.

The general principles of allocation of transaction price shall be applied to allocate the remaining amount of the transaction price that does not meet the criteria in paragraph 85 above.

Illustration 42– Allocation of variable consideration

An entity enters into a contract with a customer for two intellectual property licences (Licences A and B), which the entity determines to represent two performance obligations each satisfied at a point in time. The stand-alone selling prices of Licences A and B are ₹ 1,600,000 and ₹ 2,000,000, respectively. The entity transfers Licence B at inception of the contract and transfers Licence A one month later.

<u>Case A—Variable consideration allocated entirely to one performance obligation</u>

The price stated in the contract for Licence A is a fixed amount of ₹ 1,600,000 and for Licence B the consideration is three per cent of the customer's future sales of products that use Licence B. For purposes of allocation, the entity estimates its sales-based royalties (ie the variable consideration) to be ₹ 2,000,000. Allocate the transaction price.

<u>Case B—Variable consideration allocated on the basis of stand-alone selling prices</u>

The price stated in the contract for Licence A is a fixed amount of ₹ 600,000 and for Licence B the consideration is five per cent of the customer's future sales of products that use Licence B. The entity's estimate of the sales-based royalties (ie the variable consideration) is ₹ 3,000,000. Here, Licence A is transferred 3 months later. The royalty due from the customer's first month of sale is ₹ 4,00,000.

Allocate the transaction price and determine the revenue to be recognised for each licence and the contract liability, if any.

Solution

Case A—Variable consideration allocated entirely to one performance obligation

To allocate the transaction price, the entity considers the criteria in paragraph 85 and concludes that the variable consideration (ie the sales-based royalties) should be allocated entirely to Licence B. The entity concludes that the criteria are met for the following reasons:

(a) the variable payment relates specifically to an outcome from the performance obligation to transfer Licence B (ie the customer's subsequent sales of products that use Licence B).

(b) allocating the expected royalty amounts of ₹ 2,000,000 entirely to Licence B is consistent with the allocation objective in paragraph 73 of Ind AS 115. This is because the entity's estimate of the amount of sales-based royalties (₹ 2,000,000) approximates the stand-alone selling price of Licence B and the fixed amount of ₹ 1,600,000 approximates the stand-alone selling price of Licence A. The entity allocates ₹ 1,600,000 to Licence A. This is because, based on an assessment of the facts and circumstances relating to both licences, allocating to Licence B some of the fixed consideration in addition to all of the variable consideration would not meet the allocation objective in paragraph 73 of Ind AS 115.

The entity transfers Licence B at inception of the contract and transfers Licence A one month later. Upon the transfer of Licence B, the entity does not recognise revenue because the consideration allocated to Licence B is in the form of a sales-based royalty. Therefore, the entity recognises revenue for the sales-based royalty when those subsequent sales occur.

When Licence A is transferred, the entity recognises as revenue the ₹ 1,600,000 allocated to Licence A.

Case B—Variable consideration allocated on the basis of stand-alone selling prices

To allocate the transaction price, the entity applies the criteria in paragraph 85 of Ind AS 115 to determine whether to allocate the variable consideration (ie the sales-based royalties) entirely to Licence B.

In applying the criteria, the entity concludes that even though the variable payments relate specifically to an outcome from the performance obligation to transfer Licence B (ie the customer's subsequent sales of products that use Licence B), allocating the variable consideration entirely to Licence B would be inconsistent with the principle for allocating the transaction price. Allocating ₹ 600,000 to Licence A and ₹ 3,000,000 to Licence B does not reflect a reasonable allocation of the transaction price on the basis of the stand-alone selling prices of Licences A and B of ₹ 1,600,000 and ₹ 2,000,000, respectively. Consequently, the entity applies the general allocation requirements of Ind AS 115.

The entity allocates the transaction price of ₹ 600,000 to Licences A and B on the basis of relative stand-alone selling prices of ₹ 1,600,000 and ₹ 2,000,000, respectively. The entity also allocates the consideration related to the sales-based royalty on a relative stand-alone selling price basis. However, when an entity licenses intellectual property in which the consideration is in the form of a sales-based royalty, the entity cannot recognise revenue until the later of the following events: the subsequent sales occur or the performance obligation is satisfied (or partially satisfied).

Licence B is transferred to the customer at the inception of the contract and Licence A is transferred three months later. When Licence B is transferred, the entity recognises as revenue ₹ 333,333 [(₹ 2,000,000 ÷ ₹ 3,600,000) × ₹ 600,000] allocated to Licence B. When Licence A is transferred, the entity recognises as revenue ₹ 266,667 [(₹ 1,600,000 ÷ ₹ 3,600,000) × ₹ 600,000] allocated to Licence A.

In the first month, the royalty due from the customer's first month of sales is ₹ 400,000. Consequently, the entity recognises as revenue ₹ 222,222 (₹ 2,000,000 ÷ ₹ 3,600,000 × ₹ 400,000) allocated to Licence B (which has been transferred to the customer and is therefore a satisfied performance obligation). The entity recognises a contract liability for the ₹ 177,778 (₹ 1,600,000 ÷ ₹ 3,600,000 × ₹ 400,000) allocated to Licence A. This is because although the subsequent sale by the entity's customer has occurred, the performance obligation to which the royalty has been allocated has not been satisfied.

8.2 Changes in the transaction price

After contract inception, the transaction price can change for various reasons, including the resolution of uncertain events or other changes in circumstances that change the amount of consideration to which an entity expects to be entitled in exchange for the promised goods or services.

The following principles should be noted:

- An entity shall allocate to the performance obligations in the contract any subsequent changes in the transaction price on the same basis as at contract inception. **Consequently, an entity shall not reallocate the transaction price to reflect changes in stand-alone selling prices after contract inception.**
- Amounts allocated to a satisfied performance obligation shall be recognised as revenue, or as a reduction of revenue, in the period in which the transaction price changes.

When reallocating consideration because of a change in the transaction price, the entity continues to allocate the variable amount entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation if the criteria in Ind AS 115.85 (as discussed above) continue to be met.

If the change in transaction price is the result of a contract modification, the entity should follow the contract modification guidance.

However, when the transaction price changes after a modification, the entity should allocate the change in transaction price to the performance obligations identified before the modification if both:

- The change in the transaction price is attributable to variable consideration promised prior to the modification.
- The modification is accounted for as a termination of the old contract and the creation of a new contract.

An entity allocates all other changes in the transaction price to performance obligations under the modified contract (i.e. the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification) as long as the modification was not accounted for as a separate contract.

Changes in the transaction price should be allocated entirely to one or more, but not all, distinct goods or services promised in a series that forms part of a single performance obligation if the criteria for allocating variable consideration are met.

Illustration 43– Allocating a change in transaction price

On 1st April, 20X0, a consultant enters into an arrangement to provide due diligence, valuation, and software implementation services to a customer for ₹ 2 crore. The consultant can earn ₹ 20 lakh bonus if it completes the software implementation by 30th September, 20X0 or ₹ 10 lakh bonus if it completes the software implementation by 31st December, 20X0.

The due diligence, valuation, and software implementation services are distinct and therefore are accounted for as separate performance obligations. The consultant allocates the transaction price, disregarding the potential bonus, on a relative stand-alone selling price basis as follows:

- *Due diligence – ₹ 80 lakh*
- *Valuation – ₹ 20 lakh*
- *Software implementation – ₹ 1 crore*

At contract inception, the consultant believes it will complete the software implementation by 30th January, 20X1. After considering the factors in Ind AS 115, the consultant cannot conclude that a significant reversal in the cumulative amount of revenue recognized would not occur when the uncertainty is resolved since the consultant lacks experience in completing similar projects. As a result, the consultant does not include the amount of the early completion bonus in its estimated transaction price at contract inception.

On 1st July, 20X0, the consultant notes that the project has progressed better than expected and believes that implementation will be completed by 30th September, 20X0 based on a revised forecast. As a result, the consultant updates its estimated transaction price to reflect a bonus of ₹ 20 lakh.

After reviewing its progress as of 1st July, 20X0, the consultant determines that it is 100 percent complete in satisfying its performance obligations for due diligence and valuation and 60 percent complete in satisfying its performance obligation for software implementation.

Determine the transaction price.

Solution

On 1st July, 20X0, the consultant allocates the bonus of ₹ 20 lakh to the software implementation performance obligation, for total consideration of ₹ 1.2 crore allocated to that performance obligation, and adjusts the cumulative revenue to date for the software implementation services to ₹ 72 lakh (60 percent of ₹ 1.2 crore).

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9. STEP 5: SATISFYING PERFORMANCE OBLIGATION

An entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (i.e. an asset) to a customer. An asset is transferred when (or as) the customer obtains **control** of that asset.

In other words, the transfer of 'control' is the key determinant under Ind AS 115. This 'control model' is different from and replaces the 'risk & rewards model' under Ind AS 18. Such decision making on how 'control' will be transferred to the customer is done at the inception of transaction.

Following is a diagrammatic presentation of the aforesaid guidance:

Therefore, the key questions that need to be answered at contract inception to determine if the seller has satisfied its performance obligation are –

- Establish **what does transfer of control mean** in the context of the arrangement between the parties?
- Does the customer acquire **control over a period of time or at a point in time**?

9.1 What does transfer of control mean?

- ***Control*** of an asset refers to –

  (i) the **ability to direct the use** of, and obtain substantially all of the remaining benefits from, the asset.

(ii) Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.

- The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by:

  (a) using the asset to produce goods or provide services (including public services);

  (b) using the asset to enhance the value of other assets;

  (c) using the asset to settle liabilities or reduce expenses;

  (d) selling or exchanging the asset;

  (e) pledging the asset to secure a loan; and

  (f) holding the asset.

- In addition, an entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

  (a) The entity has a present right to payment for the asset;

  (b) The customer has legal title to the asset;

  (c) The entity has transferred physical possession of the asset;

  (d) The customer has the significant risks and rewards of ownership of the asset;

  (e) The customer has accepted the asset.

9.2 Does the customer acquire control over a period of time or at a point in time?

9.2.1 Transfer of control over a period of time:

Per para 35 of Ind AS 115, an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if **any** of the following criteria is met:

Criteria (a) – The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs;

Or

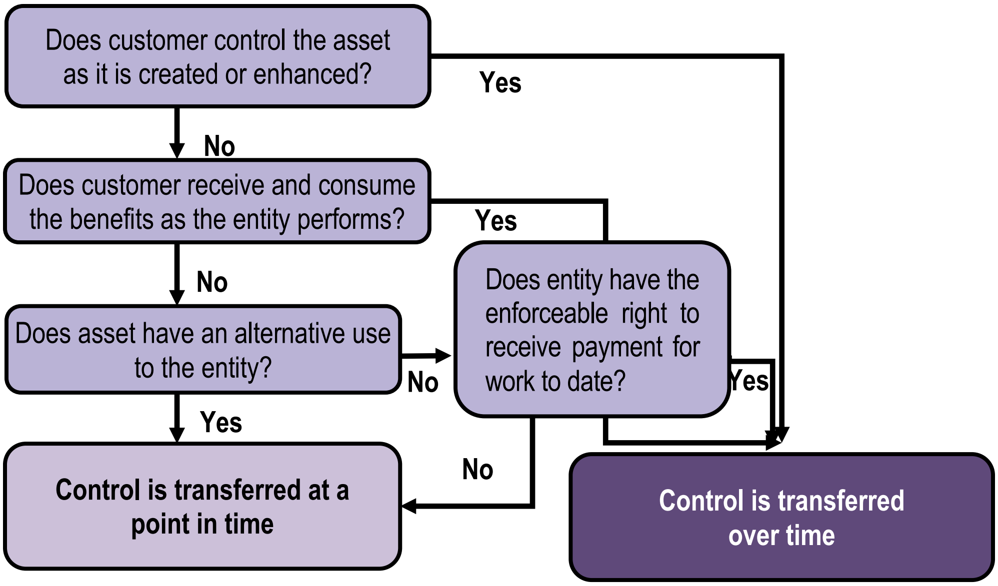
Criteria (b) – the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced; or

Or

Criteria (c) – the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

Following diagram below depicts if the control is transferred over a period of time.

- If any of the criteria are met, then revenue is recognised over a period of time.
- If none of the criteria are met, then revenue is recognised at a point in time.



In this regard, it is important to understand how each of the above criteria are evaluated –

Criteria (a) – Customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs

This criterion is ordinarily applied in situations in which the benefits of seller's performance are immediately consumed by the customer, for eg.: routine or recurring services in which the consumer consumes the benefits immediately as the services are performed, which means that the customer obtains control of seller entity's output as soon as the entity performs.

Hence, in such situations, entity's performance is said to be performed over a period of time.

Illustration 44

Minitek Ltd. is a payroll processing company. Minitek Ltd. enters into a contract to provide monthly payroll processing services to ABC limited for one year. Determine how entity will recognise the revenue?

Solution

Payroll processing is a single performance obligation. On a monthly basis, as Microtek Ltd carries out the payroll processing –

- The customer, ie, ABC Limited simultaneously receives and consumes the benefits of the entity's performance in processing each payroll transaction.

- Further, once the services have been performed for a particular month, in case of termination of the agreement before maturity and contract is transferred to another entity, then such new entity will not need to re-perform the services for expired months.

Therefore, it satisfies the first criterion, ie, services completed on a monthly basis are consumed by the entity at the same time and hence, revenue shall be recognised **o**ver the period of time.

For certain performance obligations, an entity may not be able to readily identify whether a customer simultaneously receives and consumes the benefits from the entity's performance as the entity performs. In such cases, a performance obligation is satisfied over time if an entity determines that another entity would not need to substantially re-perform the work that the entity has completed to date if that other entity were to fulfil the remaining performance obligation to the customer.

In making such determination, an entity shall make both of the following assumptions:

(a) disregard potential contractual restrictions or practical limitations that otherwise would prevent the entity from transferring the remaining performance obligation to another entity; and

(b) presume that another entity fulfilling the remainder of the performance obligation would not have the benefit of any work in progress.

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Illustration 45

T&L Limited ('T&L') is a logistics company that provides inland and sea transportation services. A customer – Horizon Limited ('Horizon') enters into a contract with T&L for transportation of its goods from India to Sri Lanka through sea. The voyage is expected to take 20 days Mumbai to Colombo. T&L is responsible for shipping the goods from Mumbai port to Colombo port.

Whether T&L's performance obligation is met over period of time?

Solution

T&L has a single performance to ship the goods from one port to another. The following factors are critical for assessing how services performed by T&L are consumed by the customer –

- As the voyage is performed, the service undertaken by T&L is progressing, such that no other entity will need to re-perform the service till so far as the voyage has been performed, if T&L was to deliver only part-way.
- The customer is directly benefitting from the performance of the voyage as & when it progresses.

Therefore, such performance obligation is said to be met over a period of time.

*****

Criteria (b) – the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced. Refer guidance on "control" given at the beginning of this section.

- In such cases, the customer ordinarily obtains control of the asset whose work is in progress and therefore, the entity carrying out the work can recognise revenue over a period of time
- Ordinarily, this criterion is applied to the following type of contracts with customers:

  (a) Construction contracts, wherein the contractor engages to construct a specific asset for the customer on customer's land;

  (b) Contracts with the government, wherein the government agency is ordinarily entitled to any work in process performed by the service provider.

Criteria (c) – the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

Where a customer does not meet either criterion (a) or criterion (b), the seller entity evaluates the third and last criterion to determine if performance obligation is satisfied over a period of time.

- This criterion refers to situations in which an asset is created at customer's discretion, which the seller is restricted from using for any other purpose and at the same time, the seller entity reserves a right to seek payment for work in process. Therefore, this criterion is met if two factors exist simultaneously –

  (i) The asset so created does not have an alternate use to the entity; and

  (ii) Seller entity has a legally enforceable right to payment for performance completed to date.

Asset has no alternate use to Seller entity	This evaluation is done at contract inception and involves consideration of following factors – ❖ For the asset created - Seller is restricted contractually from readily directing the asset for another use during its creation or enhancement; or ❖ The seller is limited practically from readily directing the asset in it completed state for another use.

And

Legally enforceable right to payment for work completed	❖ An entity has a right to payment at all times that at least compensates for performance completed to date,i.e, an amount that approximates selling price of goods which is equal to cost of goods plus a reasonable profit margin ❖ Legally enforceable right comes from operation of law or legal precedent that could supplement or override contractual terms. This may be affected if company's customary business practice is to not enforce payment if customer defaults, etc.

Let's take a closer look at each of the above mentioned factors.

❖ **Asset does not have alternate use to the seller entity:**

This evaluation is carried out at inception of transaction and is not reassessed, unless the contract is substantially modified. In doing this assessment, the entity shall consider the practical limitations and/ or contractual restrictions in redirecting the asset for another use, like selling to another customer.

- A ***contractual restriction*** referred above must be substantive, ie, a customer should be able to enforce its right to the asset if at any time the seller tries to redirect the asset to another customer. Therefore, if any customer's right to an asset is inter-changeable with other equivalent assets, then the right is not substantive to restrict the seller entity from redirecting the use of the asset.
- A ***practical limitation*** exists when the seller entity would require incurring significant economic losses to direct the asset for another use, such that the seller is practically limited from doing so. This may occur, for example, if the costs of rework of asset are significant to direct for another use, or a significant loss would occur upon selling the asset to another customer, etc.

❖ **Right to payment for performance completed to date**

- An entity has a right to payment for performance completed to date if the entity would be entitled to an amount that at least compensates the entity for its performance completed to date in the event that the customer or another party terminates the contract for reasons other than the entity's failure to perform as promised.
- Such a right to enforce payment should result in **<u>compensation for the costs incurred by the entity for work completed to date, plus a reasonable profit margin</u>**. A meagre compensation for potential loss of profit, if the contract was to be terminated does not tantamount to legally enforceable right for work completed to date.
- Compensation for a reasonable profit margin need not equal the profit margin expected if the contract was fulfilled as promised, but an entity should be entitled to compensation for either of the following amounts:

  (a) a proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination by the customer (or another party); or

  (b) a reasonable return on the entity's cost of capital for similar contracts (or the entity's typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts.
- Sometimes, the right of the entity need not be a present unconditional right. Entity may have a right to seek payment only upon achievement of specific milestones or upon completion of entire performance obligation. In such case, entity would need

to determine if it has a right to enforce payment, in case the contract was to be terminated prior to completion, for reasons other than company's failure to perform.

- Also, sometimes termination clauses in an agreement may not provide the customer with right to cancel or terminate. In such cases, if the customer seeks cancellation, the entity may still have a right to complete performance and seek payment for work carried out.
- Alternatively, if the contract provides for right to demand payment as work progresses, but customer may have a right to refund if he proposes to terminate the contract before completion. In such cases, entity cannot be said to have a right to enforce payment for work completed to date.

Illustration 46

AFS Ltd. is a risk advisory firm and enters into a contract with a company – WBC Ltd to provide audit services that results in AFS issuing an audit opinion to the Company. The professional opinion relates to facts and circumstances that are specific to the company. If the Company was to terminate the consulting contract for reasons other than the entity's failure to perform as promised, the contract requires the Company to compensate the risk advisory firm for its costs incurred plus a 15 per cent margin. The 15 per cent margin approximates the profit margin that the entity earns from similar contracts.

Whether risk advisory firm's performance obligation is met over period of time?

Solution

AFS has a single performance to provide an opinion on the professional audit services proposed to be provided under the contract with the customer. Evaluating the criterion for recognising revenue over a period of time or at a point in time, Ind AS 115 requires one of the following criterion to be met –

- Criterion (a) – whether the customer simultaneously receives and consumes the benefits from services provided by AFS: Company shall benefit only when the audit opinion is provided upon completion. And in case the contract was to be terminated, any other firm engaged to perform similar services will have to substantially re-perform.

  Hence, this criterion is not met.

- Criterion (b) – An asset created that customer controls: This is service contract and no asset created, over which customer acquires control.

- Criterion (c) – no alternate use to entity and right to seek payment:

  - The services provided by AFS are specific to the company – WBC and do not have any alternate use to AFS

❖ Further, AFS has a right to enforce payment if contract was early terminated, for reasons other than AFS's failure to perform. And the profit margin approximates what entity otherwise earns.

Therefore, criterion (c) is met and such performance obligation is said to be met over a period of time.

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Illustration 47

Space Ltd. enters into an arrangement with a government agency for construction of a space satellite. Although Space Ltd is in this business for building such satellites for various customers across the world, however the specifications for each satellite may vary based on technology that is incorporated in the satellite. In the event of termination, Company has right to enforce payment for work completed to date.

Evaluate if contract will qualify for satisfaction of performance obligation over a period of time.

Solution

While evaluating the pattern of transfer of control to the customer, the Company shall evaluate conditions laid in para 35 of Ind AS 115 as follows:

- Criterion (a) – whether the customer simultaneously receives and consumes the benefits: Customer can benefit only when the satellite is fully constructed and no benefits are consumed as its constructed. Hence, this criterion is not met.
- Criterion (b) – An asset created that customer controls: Per provided facts, the customer does not acquire control of the asset as its created.
- Criterion (c) – no alternate use to entity and right to seek payment:

  ❖ The asset is being specifically created for the customer. The asset is customised to customer's requirements, such that any diversion for a different customer will require significant work. Therefore, the asset has practical limitation in being put to alternate use.

  ❖ Further, Space Ltd.has a right to enforce payment if contract was early terminated, for reasons other than Space Ltd.'s failure to perform.

  Therefore, criterion (c) is met and such performance obligation is said to be met over a period of time.

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Illustration 48

ABC enters into a contract with a customer to build an item of equipment. The customer pays 10% advance and then 80% in instalments of 10% each over the period of construction with balance 10% payable at the end of construction period. The payments are non-refundable unless the company *fails to perform as per the contract. Further, if the customer terminates the contract, then entity is entitled to retain payments made. The company will have no further right to compensation from the customer.*

Evaluate if contract will qualify for satisfaction of performance obligation over a period of time.

Solution

The Company shall evaluate conditions laid in para 35 of Ind AS 115 as follows:

- Criterion (a) – whether the customer simultaneously receives and consumes the benefits: Customer can benefit only when the asset is fully constructed and no benefits are consumed as its constructed. Hence, this criterion is not met.
- Criterion (b) – An asset created that customer controls: Per provided facts, the customer does not acquire control of the asset as its created.
- Criterion (c) – no alternate use to entity and right to seek payment:
  - ❖ The customer has specific right over the asset and company does not have right to divert it for any alternate use. In other words, there is contractual restriction to use the asset for any alternate purpose.
  - ❖ In the event of early termination, Company has a right to retain any payments made by the customer. However, such payments need not necessarily compensate the selling price of the partially constructed asset, if the customer was to stop making payments.

Therefore, Company does not have a legally enforceable right to payment for work completed to date and the criterion under para 35 is not. Thus, revenue cannot be recognised over a period of time.

Methods of measuring progress of a performance obligation satisfied over time

Output Methods	Input Methods
Recognise revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract.	Recognise revenue on the basis of the **entity's efforts or inputs** to the satisfaction of a performance obligation.
For Example: Surveys of performance completed to date, appraisals of results achieved	**For Example**: Resources consumed labour hours expended, costs incurred, time elapsed or machine hours used

A. Output methods:

- Output method is selected if it would faithfully depict the entity's performance towards complete satisfaction of the performance obligation. It may not be useful in depicting the entity's performance if it would fail to measure some of the goods or services for which control has transferred to the customer. For example, output methods based on units produced or units delivered would not faithfully depict an entity's performance in satisfying a performance obligation if, at the end of the reporting period, the entity's performance has produced work in progress or finished goods controlled by the customer that are not included in the measurement of the output.
- **As a practical expedient** – if a company has a right to consideration from a customer in an amount which corresponds directly with the value billed to the customer of the entity's performance completed to date, then company may recognise revenue for the amount to which the entity has a right to invoice. For eg.: a service contract in which entity bills a fixed amount for each hour of service provided, etc.

B. Input methods:

- If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for the entity to recognise revenue on a straight-line basis.
- While applying input method, a careful consideration should be given for events that do not depict a direct relationship between entity's inputs and transfer of control of goods or services. For example, when cost-based input method is used, an adjustment may be required in the following cases –

  (a) When any cost incurred does not contribute to an entity's progress in satisfying performance obligation – any excess costs incurred owing to entity's inefficiencies that were not reflected in the price of the contract must be ignored for measuring progress of work. For eg: cost of wasted materials, labour or other resources, etc.

  (b) When cost incurred is not proportionate to entity's progress in satisfying its performance obligation. In such cases, the best reflection is to adjust the input method to recognise revenue only to the extent of costs incurred. Such recognition of revenue to the extent of costs incurred is appropriate, if at contract inception, all the following conditions exist:

  (i) The goods do not represent a distinct performance obligation;

  (ii) Customer is expected to obtain control of the goods significantly before receiving the services;

  (iii) Cost of such goods is significant relative to the total expected costs to complete the performance obligation; and

(iv) The entity procures the goods from a third party and does not significantly involve in designing / manufacturing the goods (even if the entity is a principal in the arrangement between the entity and end customer).

An entity shall apply a single method of measuring progress for each performance obligation satisfied over time, and the entity shall apply that method consistently to similar performance obligations and in similar circumstances. At the end of each reporting period, an entity shall remeasure its progress towards complete satisfaction of a performance obligation satisfied over time.

As circumstances change over time, an entity shall update its measure of progress to reflect any changes in the outcome of the performance obligation. Such changes to an entity's measure of progress shall be accounted for as a change in accounting estimate in accordance with Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors.

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Illustration 49: Measuring progress on straight line basis

An entity, an owner and manager of health clubs, enters into a contract with a customer for one year of access to any of its health clubs. The customer has unlimited use of the health clubs and promises to pay CU100 per month. The entity's promise to the customer is to provide a service of making the health clubs available for the customer to use as and when the customer wishes.

Evaluate if contract will qualify for satisfaction of performance obligation over a period of time. If yes, how should an entity measure its progress of service provided?

Solution

The entity shall determine if revenue should be recognised over a period of time by evaluating the conditions laid in para 35 of Ind AS 115.

- Applying the first criterion of para 35 to establish if the customer simultaneously receives and consumes the benefits, as the entity provides service – The health club provides access to services uniformly through the year. The extent to which the customer uses the health clubs does not affect the amount of the remaining goods and services to which the customer is entitled. The customer therefore simultaneously receives and consumes the benefits of the entity's performance as it performs by making the health clubs available.
- Consequently, the entity's performance obligation is satisfied over time
- Once the pattern of satisfying performance obligation is defined, the Company then determines how progress should be measured. The services are uniformly provided to the customer through the year. Therefore, the best measure of progress is to recognise revenue on a straight line basis over the year.

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Illustration 50: Uninstalled materials

On 1st January, 20X1, an entity contracts to renovate a building including the installation of new elevators. The entity estimates the following with respect to the contract:

Particulars	*Amount (₹)*
Transaction price	*5,000,000*
Expected costs:	
(a) Elevators	*1,500,000*
(b) Other costs	*2,500,000*
Total	*4,000,000*

The entity purchases the elevators and they are delivered to the site six months before they will be installed. The entity uses an input method based on cost to measure progress towards completion. The entity has incurred actual other costs of 500,000 by 31st March, 20X1.

How will the Company recognize revenue, if performance obligation is met over a period of time?

Solution

Costs to be incurred comprise two major components – elevators and cost of construction service.

(a) The elevators are part of the overall construction project and are not a distinct performance obligation

(b) The cost of elevators is substantial to the overall project and are incurred well in advance.

(c) Upon delivery at site, customer acquires control of such elevators.

(d) And there is no modification done to the elevators, which the company only procures and delivers at site. Nevertheless, as part of materials used in overall construction project, the company is a principal in the transaction with the customer for such elevators also.

Therefore, applying the guidance on Input method –

- The measure of progress should be made based on percentage of costs incurred relative to the total budgeted costs.
- The cost of elevators should be excluded when measuring such progress and revenue for such elevators should be recognized to the extent of costs incurred.

The revenue to be recognized is measured as follows:

Particulars	**Amount (₹)**
Transaction price	5,000,000
Costs incurred:	
(a) Cost of elevators	1,500,000

(b) Other costs	500,000
Measure of progress:	500,000 / 2,500,000 = 20%
Revenue to be recognised:	
(a) For costs incurred (other than elevators)	Total attributable revenue = 3,500,000 % of work completed = 20% Revenue to be recognised = 700,000
(b) Revenue for elevators	1,500,000 (equal to costs incurred)
Total revenue to be recognised	1,500,000 + 700,000 = 2,200,000

Therefore, for the year ended 31st March, 20X1, the Company shall recognize revenue of ₹ 2,200,000 on the project.

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Other considerations in measuring progress of work:

Stand-Ready Obligations

When the nature of an entity's performance obligation is to stand ready to provide goods or services, it may be appropriate to utilize a time-based measure of progress.

- When the pattern of benefit and the entity's efforts to fulfill the contract are not even throughout the contract period, a time-based method of measuring progress may not be appropriate.
- On the other hand, when an entity expects the customer will receive and consume the benefits of the entity's promise equally throughout the contract period, or if the entity does not know and cannot reasonably estimate how and when the customer will request performance, then a straight-line revenue attribution resulting from a time-based measure of progress may be appropriate.

9.2.2 Transfer of control at a point in time:

Where a company does not meet any of the aforementioned criteria for recognising revenue over a period of time, then revenue shall be recognised at a point in time.

The following is an indicative list of indicators which may exist, to imply the point of time at which control of goods has been passed to the customer. This is not an exhaustive list and there may be more factors that may be considered to determine the point of time at which revenue shall be recognised:

Indicator	Evaluation
The entity has a present right to payment	If a customer is presently obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.

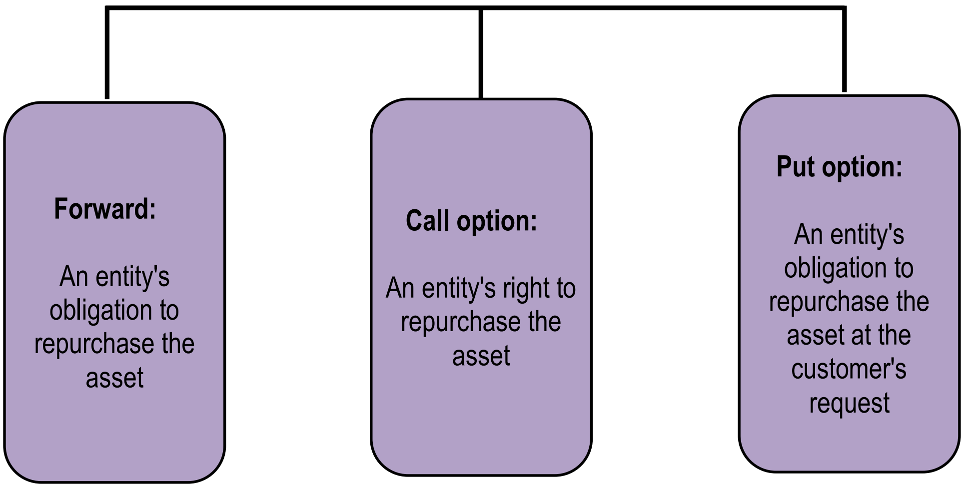
Indicator	Evaluation
The customer has a legal title to the asset	- Legal title may indicate which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. - If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.
The customer has physical possession of the asset	The customer's physical possession of an asset may indicate that the customer has the ability to direct the use of the asset. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls.
The customer has assumed significant risks & rewards of owning the asset	- Transfer of risks & rewards for an asset may indicate that the customer has the ability to direct the use of and obtain substantially all of the benefits from the asset. - When evaluating the risks and rewards of ownership of a promised asset, an entity shall exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.
The customer has accepted the asset	Customer acceptance clauses allow a customer to cancel a contract or require an entity to take remedial action if a good or service does not meet agreed-upon specifications. An entity shall consider such clauses when evaluating when a customer obtains control of a good or service. - If an entity can objectively determine that control of a good or service has been transferred to the customer in accordance with the agreed-upon specifications in the contract, then customer acceptance is a formality that would not affect the entity's determination of when the customer has obtained control of the good or service. - However, if an entity cannot objectively determine that the good or service provided to the customer is in accordance with the agreed-upon specifications in the contract, then the entity would not be able to conclude that the customer has obtained control until the entity receives the customer's acceptance.

9.3 Repurchase agreements

When a company determines the timing of transfer of control, it is important to take into consideration any repurchase agreements that may have been executed by the Company.

A repurchase agreement is a contract in which an entity sells an asset and also promises or has the option (either in the same contract or in another contract) to repurchase the asset. The repurchased asset may be the asset that was originally sold to the customer, an asset that is substantially the same as that asset, or another asset of which the asset that was originally sold is a component.

Repurchase agreements generally come in three forms



A. Forward or call option:

❖ If an entity has an obligation or a right to repurchase the asset (a forward or a call option), a customer does not obtain control of the asset because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset even though the customer may have physical possession of the asset.

Consequently, the entity shall account for the contract as either of the following:

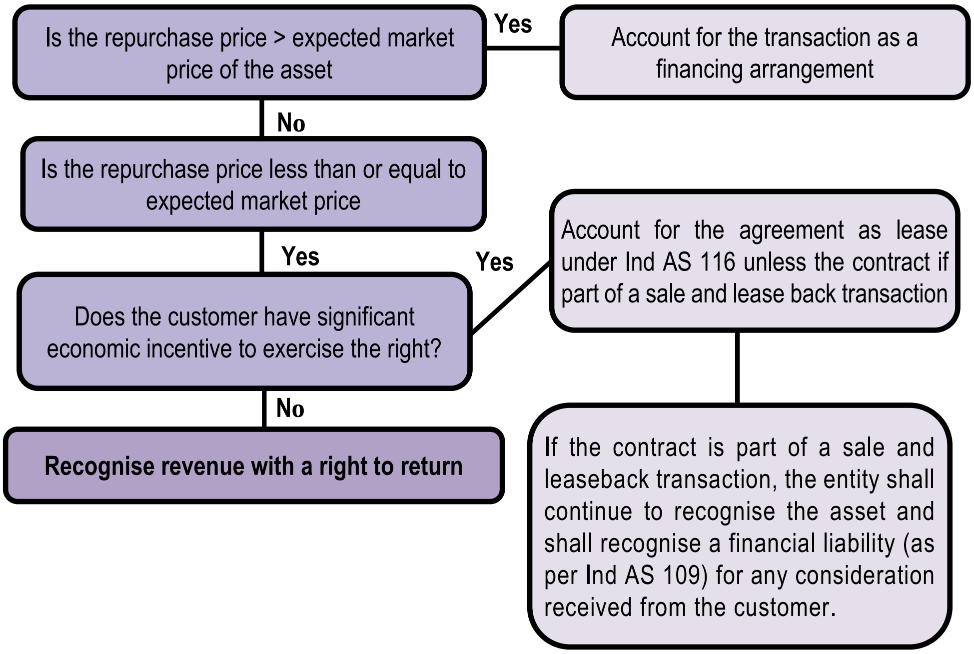
(a) ***a lease in accordance with Ind AS 116, Leases, if the entity can or must repurchase the asset for an amount that is less than the original selling price of the asset, unless the contract is part of a sale and leaseback transaction. If the contract is part of a sale and leaseback transaction, the entity shall continue to recognise the asset and shall recognise a financial liability for any consideration received from the customer. The entity shall account for the financial liability in accordance with Ind AS 109;*** or

(b) a financing arrangement, if the entity can or must repurchase the asset for an amount that is equal to or more than the original selling price of the asset.

- When comparing the repurchase price with the selling price, an entity shall consider the time value of money.
- If the repurchase agreement is a financing arrangement, the entity shall continue to recognise the asset and also recognise a financial liability for any consideration received from the customer.
- The entity shall recognise the difference between the amount of consideration received from the customer and the amount of consideration to be paid to the customer as interest and, if applicable, as processing or holding costs (for example, insurance).
- If the option lapses unexercised, an entity shall derecognise the liability and recognise revenue.

B. Put option

- If an entity has an obligation to repurchase the asset at the customer's request (a put option) at a price that is lower than the original selling price of the asset, the entity shall consider at contract inception whether the customer has a significant economic incentive to exercise that right. The customer's exercising of that right results in the customer effectively paying the entity consideration for the right to use a specified asset for a period of time. Therefore, the entity shall account for the agreement as a lease in accordance with ***Ind AS 116, unless the contract is part of a sale and leaseback transaction. If the contract is part of a sale and leaseback transaction, the entity shall continue to recognise the asset and shall recognise a financial liability for any consideration received from the customer. The entity shall account for the financial liability in accordance with Ind AS 109.***
- To determine whether a customer has a significant economic incentive to exercise its right, an entity shall consider various factors, including the relationship of the repurchase price to the expected market value of the asset at the date of the repurchase and the amount of time until the right expires. For example, if the repurchase price is expected to significantly exceed the market value of the asset, this may indicate that the customer has a significant economic incentive to exercise the put option.
- If the repurchase price is equal to or greater than original selling price and more than the expected market value of the asset, the contract is in effect a financing arrangement.
- If the repurchase price of the asset is equal to or greater than the original selling price and is less than or equal to the expected market value of the asset, and the customer does not have a significant economic incentive to exercise its right, then the entity shall account for the agreement as if it were the sale of a product with a right of return.
- If the customer does not have a significant economic incentive to exercise its right at a price that is lower than the original selling price of the asset, the entity shall account for the agreement as if it were the sale of a product with a right of return.
- The following decision tree may be useful to account for the arrangement –



❖ When comparing the repurchase price with the selling price, an entity shall consider the time value of money.

❖ If the option lapses unexercised, an entity shall derecognise the liability and recognise revenue.

Illustration 51

An entity enters into a contract with a customer for the sale of a tangible asset on 1st January, 20X1 for ₹ 1 million. The contract includes a call option that gives the entity the right to repurchase the asset for ₹ 1.1 million on or before 31st December, 20X1.

How would the entity account for this transaction?

Solution

In the above case, where the entity has a right to call back the goods upto a certain date –

- The customer cannot be said to have acquired control, owing to the repurchase right with the seller entity
- Since the original selling price (₹ 1 million) is lower than the repurchase price (₹ 1.1 million), this is construed to be a financing arrangement and accounted as follows:

  (a) Amount received shall be recognized as 'liability'

  (b) Difference between sale price and repurchase price to be recognised as 'finance cost' and recognised over the repurchase term.

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Illustration 52

An entity enters into a contract with a customer for the sale of a tangible asset on 1st January, 20X1 for ₹ 1,000,000. The contract includes a put option that gives the customer the right to sell the asset for ₹ 900,000 on or before 31st December, 20X1. The market price for such goods is expected to be ₹ 750,000

How would the entity account for this transaction?

Solution

In the above case, where the entity has an obligation to buy back the goods upto a certain date–

- The entity shall evaluate if the customer has a significant economic incentive to return the goods. Since the repurchase price is significantly higher than market price, therefore, customer has a significant economic incentive to return the goods. There are no other factors which entity may affect this assessment.
- Therefore, company determines that 'control' of goods is not transferred to the customer till 31st December, 20X1, ie, till the put option expires.
- Against payment of ₹ 1,000,000; the customer only has a right to use the asset and put it back to the entity for ₹ 900,000. Therefore, this will be accounted as a lease transaction in which difference between original selling price (ie, ₹ 1,000,000) and repurchase price (ie, ₹ 900,000) shall be recognized as lease income over the period of lease.
- At the end of repurchase term, ie, 31st December, 20X1, if the customer does not exercise such right, then the control of goods would be passed to the customer at that time and revenue shall be recognized for sale of goods for repurchase price (ie, ₹ 900,000).

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9.4 Bill-and-hold

- ❖ A bill-and-hold arrangement is a contract under which an entity bills a customer for a product but the entity retains physical possession of the product until it is transferred to the customer at a point in time in the future. For example, a customer may request an entity to enter into such a contract because of the customer's lack of available space for the product or because of delays in the customer's production schedules.
- ❖ In such arrangements, the entity shall determine at which point does control transfer to the customer.

  In some cases, control is transferred either when the product is delivered to the customer's site or when the product is shipped, depending on the terms of the contract (including delivery and shipping terms). While in other cases, a customer may obtain control of a product even though that product remains in an entity's physical possession. In that case, the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the product even though it has decided not to exercise its right to take physical possession of that product. Consequently, the entity does not control the product. Instead, the entity provides custodial services to the customer over the customer's asset

❖ In addition, the indicators defined earlier in this chapter for establishing transfer of control, **all the following criteria must be met**:

(a) the reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement);

(b) the product must be identified separately as belonging to the customer;

(c) the product currently must be ready for physical transfer to the customer; and

(d) the entity cannot have the ability to use the product or to direct it to another customer.

❖ Where an entity recognises revenue on bill & hold basis, the entity shall determine if it has any additional performance obligations forming part of the transaction price, which would need to be segregated and accounted separately, when such performance obligations are met. (for eg.: custodial services for goods held, extended warranty, etc.) For identification of performance obligations, refer step 2 – identifying performance obligations.

Illustration 53

An entity enters into a contract with a customer on 1st April, 20X1 for the sale of a machine and spare parts. The manufacturing lead time for the machine and spare parts is two years.

Upon completion of manufacturing, the entity demonstrates that the machine and spare parts meet the agreed-upon specifications in the contract. The promises to transfer the machine and spare parts are distinct and result in two performance obligations that each will be satisfied at a point in time. On 31st March, 20X3, the customer pays for the machine and spare parts, but only takes physical possession of the machine. Although the customer inspects and accepts the spare parts, the customer requests that the spare parts be stored at the entity's warehouse because of its close proximity to the customer's factory. The customer has legal title to the spare parts and the parts can be identified as belonging to the customer. Furthermore, the entity stores the spare parts in a separate section of its warehouse and the parts are ready for immediate shipment at the customer's request. The entity expects to hold the spare parts for two to four years and the entity does not have the ability to use the spare parts or direct them to another customer.

How will the Company recognise revenue for sale of machine and spare parts? Is there any other performance obligation attached to this sale of goods?

Solution

In the facts provided above, the entity has made sale of two goods – machine and space parts, whose control is transferred at a point in time. Additionally, company agrees to hold the spare parts for the customer for a period of 2-4 years, which is a separate performance obligation. Therefore, total transaction price shall be divided amongst 3 performance obligations –

(i) Sale of machinery

(ii) Sale of spare parts

(iii) Custodial services for storing spare parts.

Recognition of revenue for each of the three performance obligations shall occur as follows:

- Sale of machinery: Machine has been sold to the customer and physical possession as well as legal title passed to the customer on 31st March, 20X3. Accordingly, revenue for sale of machinery shall be recognised on 31st March, 20X3.

- Sale of spare parts: The customer has made payment for the spare parts and legal title has been passed to specifically identified goods, but such spares continue to be physically held by the entity. In this regard, the company shall evaluate if revenue can be recognized on bill-n-hold basis if all below criteria are met:

(a) the reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement);	The customer has specifically requested for entity to store goods in their warehouse, owing to close proximity to customer's factory.
(b) the product must be identified separately as belonging to the customer;	The spare parts have been specifically identified and inspected by the customer.
(c) the product currently must be ready for physical transfer to the customer; and	The spares are identified and segregated, therefore, read for delivery.
(d) the entity cannot have the ability to use the product or to direct it to another customer	Spares have been segregated and cannot be redirected to any other customer.

Therefore, all conditions of bill-and-hold are met and hence, company can recognize revenue for sale of spare parts on 31st March, 20X3.

- Custodial services: Such services shall be given for a period of 2 to 4 years from 31st March, 20X3. Where services are given uniformly and customer receives & consumes benefits simultaneously, revenue for such service shall be recognized on a straight line basis over a period of time.

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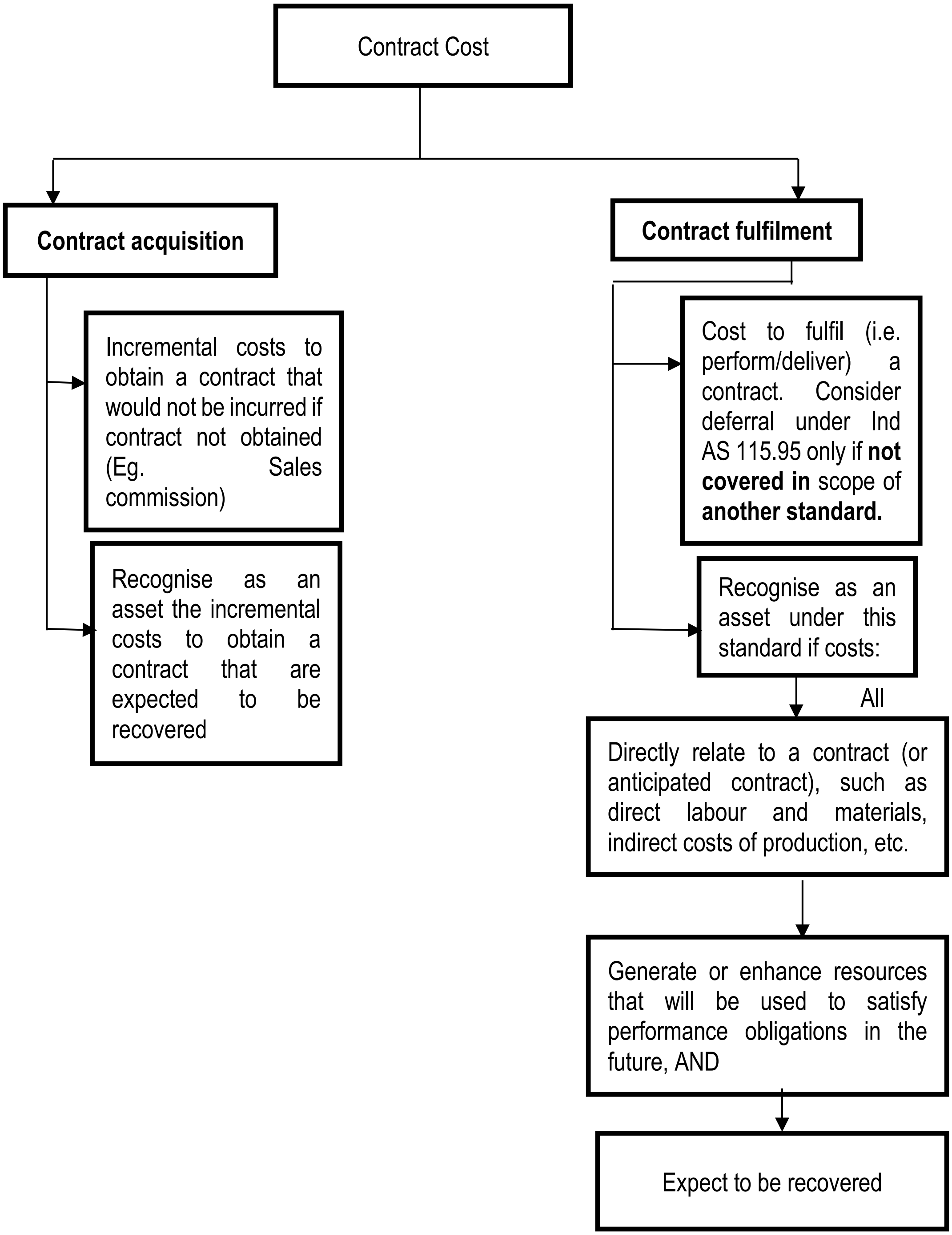
10. CONTRACT COSTS



10.1 Costs to obtain a contract (contract acquisition costs)

Entities may incur various costs to obtain or acquire a contract with a customer, including, but not limited to, legal fees, advertising expenses, travel expenses, and salespersons' salaries and commissions.

Incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).

Once an entity has determined that costs incurred relate to a specific contract with a customer, it should then determine if the costs meet the conditions for capitalisation. Incremental costs to obtain a contract that an entity expects to recover should be capitalised, while costs to obtain a contract that do not qualify for capitalisation should be expensed as incurred.

The test to determine if a cost is incremental is to ask whether the entity would have incurred the cost had one or both of the parties decided to walk away just before signing the arrangement. In this context, any legal costs (for example, to draft or negotiate the contract) or salaries for salespeople would be incurred regardless of whether the contract is finalized. Therefore, these costs are not incremental. On the other hand, a commission paid only upon the successful signing of the contract would be incremental and should be capitalized.

As a practical expedient, Ind AS 115 allows an entity to expense the incremental costs of obtaining a contract as incurred if the amortisation period of the asset that the entity would have otherwise recognised is one year or less.

Cost	Capitalize or expense	Reason
Commission paid only upon successful signing of a contract	Capitalize	Assuming the entity expects to recover the cost, the commission is incremental since it would not have been paid if the parties decided not to enter into the arrangement just before signing.
Travel expenses for sales persons pitching a new client contract	Expense	Because the costs are incurred regardless of whether the new contract is won or lost, the entity expenses the costs, unless they are expressly reimbursable.
Legal fees for drafting terms of arrangement for parties to approve and sign	Expense	If the parties walk away during negotiations, the costs would still be incurred and therefore are not incremental costs of obtaining the contract.
Salaries for sales people working exclusively on obtaining new clients	Expense	The salaries are incurred regardless of whether contracts are won or lost and

Cost	Capitalize or expense	Reason
		therefore are not incremental costs to obtain the contract.
Bonus based on quarterly sales target	Capitalize	Bonuses based solely on sales are incremental costs to obtain a contracts.
Commission paid to sales manager based on contracts obtained by the sales manager's local employees	Capitalize	The commissions are incremental costs that would not have been incurred had the entity not obtained the contract. Ind AS 115 does not differentiate costs based on the function or title of the employee that receives the commission.

10.2 Costs to fulfil a contract (contract fulfilment costs)

If costs incurred in fulfilling a contract with a customer are covered under another Standard (such as Ind AS 2 'Inventory' and Ind AS 16 'Property, Plant, and Equipment'), an entity accounts for those costs in accordance with those Standards. If not, an entity recognises an asset for such costs, provided all of the criteria mentioned below are met:

(a) the costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved), including:

   (i) direct labour

   (ii) direct materials

   (iii) allocations that relate directly to the contract or contract activities (for example, contract management and supervision costs and depreciation of tools and equipment ***and right-of-use assets*** used in fulfilling the contract)

   (iv) costs that are explicitly chargeable to the customer

   (v) other costs that the entity incurs only because it entered into the contract (e.g. payments to subcontractors)

(b) the costs generate or enhance resources of the entity that will be used to satisfy performance obligations in the future

(c) the entity expects to recover the costs, for e.g. through the expected margin

The following costs should be expensed as incurred:

(a) general and administrative costs that are not explicitly chargeable to the customer

(b) costs of wasted materials, labour, or other resources that were not reflected in the contract price

(c) costs that relate to satisfied performance obligations

(d) costs related to remaining performance obligations that cannot be distinguished from costs related to satisfied performance obligations.

Costs incurred in fulfilling a contract with a customer that are within the scope of another Standard, an entity shall account for those costs in accordance with those other Standards.

Illustration 54

Customer outsources its information technology data centre

Term = 5 years plus two 1-yr renewal options

Average customer relationship is 7 years

Entity spends ₹ 400,000 designing and building the technology platform needed to accommodate out-sourcing contract:

Design services	*₹ 50,000*
Hardware	*₹ 140,000*
Software	*₹ 100,000*
Migration and testing of data centre	*₹ 110,000*
TOTAL	***₹ 400,000***

How should such costs be treated?

Solution

Design services	₹ 50,000	Assess under Ind AS 115. Any resulting asset would be amortised over 7 years (i.e. include renewals)
Hardware	₹ 140,000	Account for asset under Ind AS 16
Software	₹ 100,000	Account for asset under Ind AS 38
Migration and testing of data centre	₹ 110,000	Assess under Ind AS 115. Any resulting asset would be amortised over 7 years (i.e. include renewals)
TOTAL	**₹ 400,000**	

10.3 Amortisation and impairment

Under Ind AS 115, an entity amortises capitalised contract costs on a systematic basis consistent with the pattern of transferring the goods or services related to those costs. If an entity identifies a significant change to the expected pattern of transfer, it updates its amortisation to reflect that change in estimate in accordance with Ind AS 8.

An entity recognises an impairment loss in earnings if the carrying amount of an asset exceeds the remaining amount of consideration that the entity expects to receive in connection with the related goods or services less any directly related contract costs yet to be recognised. When determining the amount of consideration it expects to receive, an entity ignores the constraint on variable consideration previously discussed, and adjusts for the effects of the customer's credit risk.

Before recognising an impairment loss under the revenue recognition guidance, an entity recognises impairment losses associated with assets related to the contract that are accounted in accordance with another Standard (for example, Ind AS 2, Ind AS 16 and Ind AS 38).

An entity would reverse a previously recognised impairment loss when the impairment conditions no longer exist or have improved. The increased carrying amount of the asset shall not exceed the amount that would have been determined (net of amortisation) if no impairment loss had been recognised previously.

Illustration 55: Amortisation

An entity enters into a service contract with a customer and incurs incremental costs to obtain the contract and costs to fulfil the contract. These costs are capitalised as assets in accordance with Ind AS 115. The initial term of the contract is five years but it can be renewed for subsequent one-year periods up to a maximum of 10 years. The average contract term for similar contracts entered into by entity is seven years.

Determine appropriate method of amortisation?

Solution

The most appropriate amortisation period is likely to be seven years (i.e. the initial term of five years plus two anticipated one year renewals) because that is the period over which the entity expects to provide services under the contract to which the capitalised costs relate.

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11. PRESENTATION & DISCLOSURE

11.1 Presentation

Under Ind AS 115, an entity presents a contract in its balance sheet as a contract liability, a contract asset, or a receivable, depending on the relationship between the entity's performance and the customer's payment at the reporting date.An entity shall present any unconditional rights to consideration separately as a receivable.

An entity presents a contract as a contract liability if the customer has paid consideration, or if payment is due as of the reporting date but the entity has not yet satisfied a performance obligation by transferring a good or service. Conversely, if the entity has transferred goods or services as of the reporting date but the customer has not yet paid, the entity recognises either a contract asset or a receivable. An entity recognises a contract asset if it's right to consideration is conditioned on something other than the passage of time; otherwise, an entity recognises a receivable.

A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due. An entity shall account for a receivable in accordance with Ind AS 109. Upon initial recognition of a receivable from a contract with a customer, any difference between the measurement of the receivable in accordance with Ind AS 109 and the corresponding amount of revenue recognised shall be presented as an expense.

An entity shall also present separately the amount of excise duty included in the revenue recognised in the statement of profit and loss. This is an additional requirement inserted due to the Indian context in Ind AS 115.

11.2 Disclosure

Ind AS 115 requires many new disclosures about contracts with customers. The following table provides a summary:

Disclosures	
Disclosure area	**Summary of requirements**
General	• revenue recognised from contracts with customers, separately from its other sources of revenue • impairment losses on receivables or contract assets
Disaggregation of revenue	• categories that depict the nature, amount, timing, and uncertainty of revenue and cash flows • sufficient information to enable users of financial statements to understand the relationship with revenue information disclosed for reportable segments under Ind AS 108 'Operating Segments'
Information about contract balances	• including opening and closing balances of contract assets, contract liabilities, and receivables (if not separately presented) • revenue recognised in the period that was included in contract liabilities at the beginning of the period and revenue from performance obligations (wholly or partly) satisfied in prior periods • explanation of relationship between timing of satisfying performance obligations and payment • explanation of significant changes in the balances of contract assets and liabilities

Information about performance obligations	• when the entity typically satisfies performance obligations • significant payment terms • nature of goods and services • obligations for returns, refunds and similar obligations • types of warranties and related obligations
Transaction price allocated to the remaining performance obligations	• transaction price allocated to the performance obligations that are unsatisfied and an explanation of when the entity expects to recognise such revenue.
Timing of satisfaction of performance obligations	• performance obligations that an entity satisfies over time: o methods used to recognise revenue o why the methods used provide a faithful depiction • performance obligations satisfied at a point in time: o judgements made in evaluating when a customer obtains control
Information about significant judgements	• judgements impacting the expected timing of satisfying performance obligations transaction price and amounts allocated to performance obligations (e.g. estimating variable consideration and assessing if constrained and allocating to performance obligations).
Transaction price and amount allocated to performance obligations	• determining transaction price, estimating variable consideration, adjusting the consideration for the effects of the time value of money and measuring non-cash consideration • estimate of variable consideration is constrained • measuring obligations for returns, refunds and other similar obligations • allocating the transaction price, discounts and variable consideration to a specific part of the contract • reconcile the amount of revenue recognised in the statement of profit and loss with the contracted price
Assets recognised from the costs to obtain or fulfil a contract	• judgements made in determining costs amount of the costs incurred • to obtain or fulfil a contract with a customer • amortisation method used • closing balances by main category and amortisation expense
Practical expedients	• practical expedient elected by an entity in either paragraph 63 (about the existence of a significant financing component) or paragraph 94 (about the incremental costs of obtaining a contract)

12. SERVICE CONCESSION ARRANGEMENTS

12.1 About Arrangement

- Service Concession Arrangement involves a private sector entity (an operator) constructing the infrastructure used to provide the public service or upgrading it (for example, by increasing its capacity) and operating and maintaining that infrastructure for a specified period of time. The operator is paid for its services over the period of the arrangement. The arrangement is governed by a contract that sets out performance standards, mechanisms for adjusting prices, and arrangements for arbitrating disputes.
- Such an arrangement is often described as a 'build-operate-transfer', a 'rehabilitate-operate-transfer' or a 'public-to-private' service concession arrangement.

Example

Infrastructure for public services—such as roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and telecommunication networks—has traditionally been constructed, operated and maintained by the public sector and financed through public budget appropriation.

- A feature of these service arrangements is the public service nature of the obligation undertaken by the operator.
- Public policy is for the services related to the infrastructure to be provided to the public, irrespective of the identity of the party that operates the services. The service arrangement contractually obliges the operator to provide the services to the public on behalf of the public sector entity. Other common features are:

  (a) the party that grants the service arrangement (the grantor) is a public sector entity, including a governmental body, or a private sector entity to which the responsibility for the service has been devolved.

  (b) the operator is responsible for at least some of the management of the infrastructure and related services and does not merely act as an agent on behalf of the grantor.

  (c) the contract sets the initial prices to be levied by the operator and regulates price revisions over the period of the service arrangement.

  (d) the operator is obliged to hand over the infrastructure to the grantor in a specified condition at the end of the period of the arrangement, for little or no incremental consideration, irrespective of which party initially financed it.

12.2 Accounting Principles

12.2.1 Treatment of the operator's rights over the infrastructure

- Infrastructure shall not be recognised as property, plant and equipment of the operator because the contractual service arrangement does not convey the right to control the use of the public service infrastructure to the operator.

- The operator has access to operate the infrastructure to provide the public service on behalf of the grantor in accordance with the terms specified in the contract.

12.2.2 Recognition and measurement

- Since the operator acts as a service provider, he shall recognise and measure revenue in accordance with Ind AS 115 for the services it performs. The operator constructs or upgrades infrastructure (construction or upgrade services) used to provide a public service and operates and maintains that infrastructure (operation services) for a specified period of time.
- If the operator performs more than one service (ie construction or upgrade services and operation services) under a single contract or arrangement, consideration received or receivable shall be allocated by reference to the relative fair values of the services delivered, when the amounts are separately identifiable.
- The nature of the consideration i.e. whether financial asset or intangible asset determines its subsequent accounting treatment.
- The operator shall account for revenue and costs relating to construction or upgrade services.
- The operator shall account for revenue and costs relating to operation services in accordance with Ind AS 115.

12.2.3 Consideration given by the grantor to the operator

- If the operator provides construction or upgrade services, the consideration received or receivable by the operator shall be recognized at its fair value. The consideration may be rights to:

  (a) a financial asset, or

  (b) an intangible asset.
- The operator shall recognise a financial asset to the extent that
  - it has an unconditional contractual right to receive cash or another financial asset from or at the direction of the grantor for the construction services; the grantor has little, if any, discretion to avoid payment, usually because the agreement is enforceable by law.
  - it has an unconditional right to receive cash if the grantor contractually guarantees to pay the operator (a) specified or determinable amounts or (b) the shortfall, if any, between amounts received from users of the public service and specified or determinable amounts, even if payment is contingent on the operator ensuring that the infrastructure meets specified quality or efficiency requirements.
- The operator shall recognise an intangible asset to the extent that it receives a right (a licence) to charge users of the public service. A right to charge users of the public service is not an unconditional right to receive cash because the amounts are contingent on the extent that the public uses the service.
- If the operator is paid for the construction services partly by a financial asset and partly by an intangible asset it is necessary to account separately for each component of the operator's consideration. The consideration received or receivable for both components shall be recognised initially at the fair value of the consideration received or receivable.

12.2.4 Contractual obligations to restore the infrastructure to a specified level of serviceability

The operator may have contractual obligations it must fulfil as a condition of its licence, like to maintain or restore infrastructure, except for any upgrade element, which shall be recognised and measured in accordance with Ind AS 37, ie at the best estimate of the expenditure that would be required to settle the present obligation at the end of the reporting period.

12.2.5 Borrowing costs incurred by the operator

- Borrowing costs attributable to the arrangement shall be recognised as an expense in the period in which they are incurred unless the operator has a contractual right to receive an intangible asset (a right to charge users of the public service).
- If the operator does not have a contractual right to receive an intangible asset, borrowing costs attributable to the arrangement shall be capitalised during the construction phase of the arrangement.

12.2.6 Financial asset

- For recognition of financial asset, Ind AS 32, Ind AS 107 and Ind AS 109 shall be applied. The amount due from or at the direction of the grantor is accounted at:
  (a) amortised cost;
  (b) fair value through other comprehensive income; or
  (c) fair value through profit or loss.
- If the amount due from the grantor is measured at amortised cost or fair value through other comprehensive income, Ind AS 109 requires interest calculated using the effective interest method to be recognised in profit or loss.

12.2.7 Intangible asset

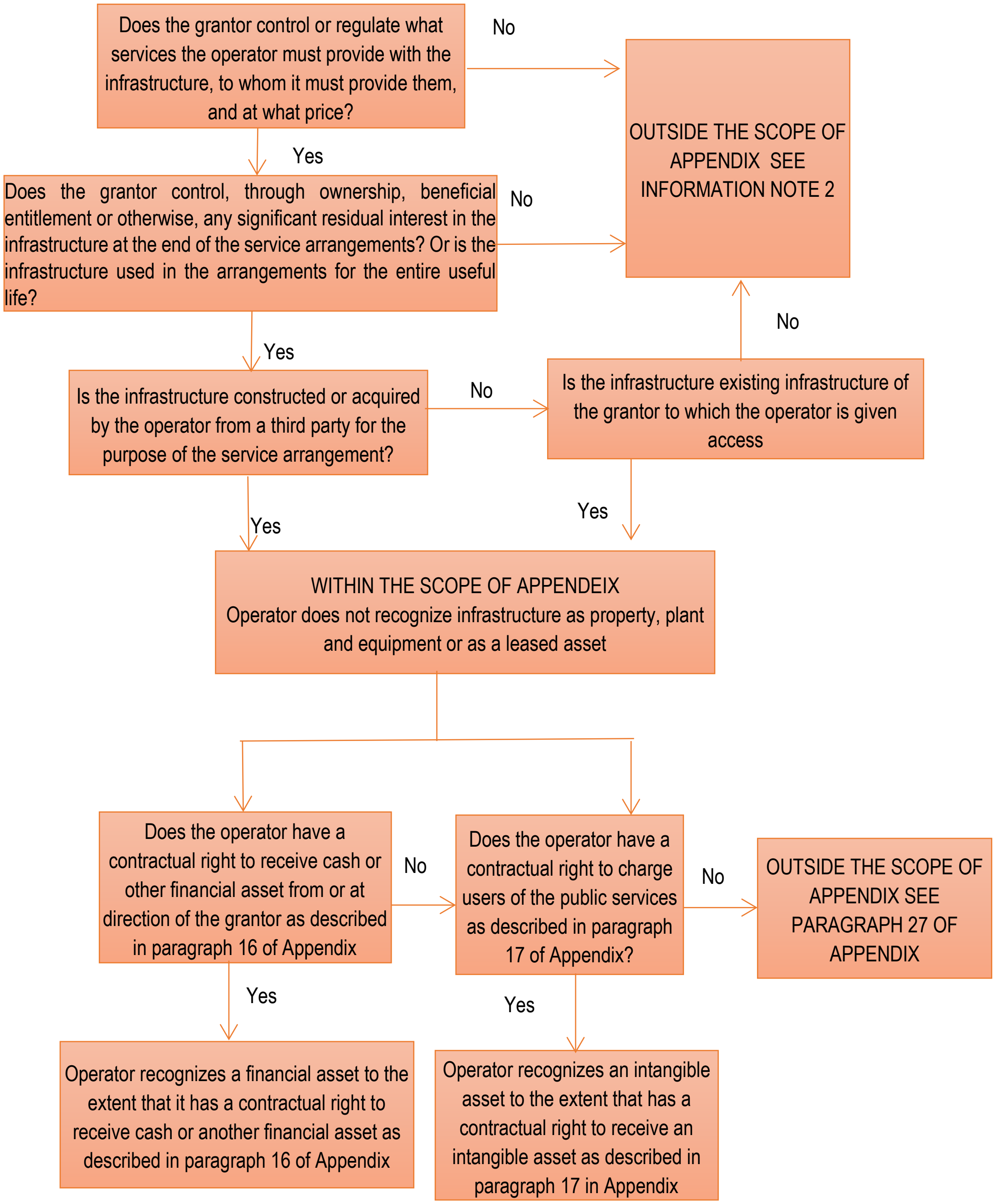
For recognition and measurement of intangible asset, one has to apply Ind AS 38 for guidance on measuring intangible assets acquired in exchange for a non-monetary asset or assets or a combination of monetary and non-monetary assets.

12.2.8 Items provided to the operator by the grantor

- Infrastructure items to which the operator is given access by the grantor for the purposes of the service arrangement are not recognised as property, plant and equipment of the operator.
- The grantor may also provide other items to the operator that the operator can keep or deal with as it wishes. If such assets form part of the consideration payable by the grantor for the services, they are not government grants as defined in Ind AS 20. They are recognised as assets of the operator, measured at fair value on initial recognition.
- The operator shall recognise a liability in respect of unfulfilled obligations it has assumed in exchange for the assets.

Information note 1

Accounting framework for public-to-private service arrangements



12.3 Service Concession Arrangements: Disclosures

- All aspects of a service concession arrangement shall be considered in determining the appropriate disclosures in the notes. An operator and a grantor shall disclose the following in each period:
  - (a) a description of the arrangement;
  - (b) significant terms of the arrangement that may affect the amount, timing and certainty of future cash flows (eg the period of the concession, re-pricing dates and the basis upon which re-pricing or re-negotiation is determined);
  - (c) the nature and extent (eg quantity, time period or amount as appropriate) of:
    - (i) rights to use specified assets;
    - (ii) obligations to provide or rights to expect provision of services;
    - (iii) obligations to acquire or build items of property, plant and equipment;
    - (iv) obligations to deliver or rights to receive specified assets at the end of the concession period;
    - (v) renewal and termination options; and
    - (vi) other rights and obligations (eg major overhauls);
  - (d) changes in the arrangement occurring during the period; and
  - (e) how the service arrangement has been classified.
- An operator shall disclose the amount of revenue and profits or losses recognized in the period on exchanging construction services for a financial asset or an intangible asset.
- The disclosures required in accordance with paragraph 6 of this Appendix shall be provided individually for each service concession arrangement or in aggregate for each class of service concession arrangements. A class is a grouping of service concession arrangements involving services of a similar nature (eg toll collections, telecommunications and water treatment services).

Illustration 56

A Ltd. is in the business of the infrastructure and has two divisions under the same; (I) Toll Roads and (II) Wind Power. The brief details of these business and underlying project details are as follows:

I. Bhilwara-Jabalpur Toll Project - The Company has commenced the construction of the project in the current year and has incurred total expenses aggregating to ₹ 50 crore as on 31st December, 20X1. Under IGAAP, the Company has 'recorded such expenses as Intangible Assets in the books of account. The brief details of the Concession Agreement are as follows:

- *Total Expenses estimated to be incurred on the project ₹ 100 crore;*
- *Fair Value of the construction services is ₹ 110 crore;*
- *Total Cash Flow guaranteed by the Government under the concession agreement is ₹ 200 crore;*
- *Finance revenue over the period of operation phase is ₹ 15 crore:*
- *Other income relates to the services provided during the operation phase.*

II. Kolhapur- Nagpur Expressway - The Company has also entered into another concession agreement with Government of Maharashtra in the current year. The construction cost for the said project will be ₹ 110 crore. The fair value of such construction cost is approximately ₹ 200 crore. The said concession agreement is Toll based project and the Company needs to collect the toll from the users of the expressway. Under IGAAP, UK Ltd. has recorded the expenses incurred on the said project as an Intangible Asset.

Required

(i) What would be the classification of Bhilwara-Jabalpur Toll Project as per applicable Ind AS? Give brief reasoning for your choice.

(ii) What would be the classification of Kolhapur-Nagpur Expressway Toll Project as per applicable Ind AS? Give brief reasoning for your choice.

(iii) Also, suggest suitable accounting treatment for preparation of financial statements as per Ind AS for the above 2 projects.

Solution

(i) Here the operator has a contractual right to receive cash from the grantor. The grantor has little, if any, discretion to avoid payment, usually because the agreement is enforceable by law. The operator has an unconditional right to receive cash if the grantor contractually guarantees to pay the operator. Hence, operator recognizes a financial asset to the extent it has a contractual right to receive cash.

(ii) Here the operator has a contractual right to charge users of the public services. A right to charge users of the public service is not an unconditional right to receive cash because the amounts are contingent on the extent that the public uses the service. Therefore, the operator shall recognise an intangible asset to the extent it receives a right (a licence) to charge users of the public service.

(iii) Accounting treatment for preparation of financial statements

Bhilwara-Jabalpur Toll Project

Journal Entries

	Particulars	Dr. (₹ in crore)	Cr. (₹ in crore)
	During construction:		
1	Financial asset A/c Dr.	110	
	To Construction revenue		110
	[To recognise revenue relating to construction services, to be settled in case]		
2	Cost of construction (profit or loss) Dr.	100	
	To Bank A/c (As and when incurred)		100
	[To recognise costs relating to construction services]		
	During the operation phase:		
3	Financial asset Dr.	15	
	To Finance revenue (As and when received or due to receive)		15
	[To recognise interest income under the financial asset model]		
4	Financial asset Dr.	75	
	To Revenue [(200-110) – 15]		75
	[To recognise revenue relating to the operation phase]		
5	Bank A/c Dr.	200	
	To Financial asset		200
	[To recognise cash received from the grantor]		

Kolhapur-Nagpur Expressway -Intangible asset

Journal Entries

	Particulars	Dr. (₹ in crore)	Cr. (₹ in crore)
	During construction:		
1	Cost of construction (profit or loss) Dr.	110	
	To Bank A/c (As and when incurred)		110
	[To recognise costs relating to construction services]		

2	Intangible asset Dr. To Revenue [To recognise revenue relating to construction services provided for non-cash consideration]	200	200
3	During the operation phase: Amortisation expense Dr. To Intangible asset (accumulated amortisation) [To recognise amortisation expense relating to the operation phase over the period of operation]	200	200
4	Bank A/c Dr. To Revenue [To recognise revenue relating to the operation phase]	?	?

Note: Amount in entry 4 is kept blank as no information in this regard is given in the question.

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13. SIGNIFICANT DIFFERENCES IN IND AS 115 *VIS-À-VIS* AS 7 AND AS 9

S. No.	Particular	Ind AS 115	AS 7 and AS 9
1.	*Framework of Revenue Recognition*	Ind AS 115 gives a framework of revenue recognition within a standard. It specifies the core principle for revenue recognition which requires the 'revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services'.	AS 7 and AS 9 do not provide any such overarching principle to fall upon in case of doubt.
2.	*Comprehensive Guidance on Recognition and Measurement of Multiple Elements within a Contract with Customer:*	Ind AS 115 gives comprehensive guidance on how to recognise and measure multiple elements within a contract with customer.	AS 7 and AS 9 do not provide comprehensive guidance on this aspect.

3.	*Coverage*	Ind AS 115 comprehensively deals with all types of performance obligation contract with customer. However, it does not deal with revenue from 'interest' and 'dividend' which are covered in financial instruments standard.	AS 7 covers only revenue from construction contracts which is measured at consideration received / receivable. AS 9 deals only with recognition of revenue from sale of goods, rendering of services, interest, royalties and dividends.
4.	*Measurement of Revenue*	As per Ind AS 115, revenue is measured at transaction price, i.e., the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.	As per AS 9, Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. As per AS 7, revenue from construction contracts is measured at consideration received / receivable and to be recognised as revenue as construction progresses, if certain conditions are met.
5.	*Recognition of Revenue*	As per Ind AS 115, revenue is recognised when the control is transferred to the customer.	As per AS 9, revenue is recognised when significant risks and rewards of ownership is transferred to the buyer. As per AS 7, revenue is recognised when the outcome of a construction contract can be estimated reliably, contract revenue should be recognised by reference to the stage of completion of the contract activity at the reporting date.

6.	*Capitalisation of Costs*	Ind AS 115 provides guidance on recognition of costs to obtain and fulfill a contract, as asset	AS 7 and AS 9 do not deal with such capitalisation of costs.
7.	*Guidance on Service Concession Arrangements*	Ind AS 115 gives guidance on service concession arrangements and disclosures thereof	AS does not provide such guidance.
8.	*Disclosure Requirements*	Ind AS 115 contains detailed disclosure requirements.	Less disclosure requirements are prescribed in AS

14. CARVE OUT IN IND AS 115 FROM IFRS 15

As per IFRS

IFRS 15 provides that all types of penalties which may be levied in the performance of a contract should be considered in the nature of variable consideration for recognising revenue.

Carve out

Ind AS 115 has been amended to provide that penalties shall be accounted for as per the substance of the contract. Where the penalty is inherent in determination of transaction price, it shall form part of variable consideration, otherwise the same should not be considered for determining the consideration and the transaction price shall be considered as fixed.

TEST YOUR KNOWLEDGE

Questions

1. Q TV released an advertisement in Deshabandhu, a vernacular daily. Instead of paying for the same, Q TV allowed Deshabandhu a free advertisement spot, which was duly utilised by Deshabandu. How revenue for these nonmonetary transactions in the area of advertising will be recognised and measured?

2. A Ltd. a telecommunication company, entered into an agreement with B Ltd. which is engaged in generation and supply of power. The agreement provided that A Ltd. will provide 1,00,000 minutes of talk time to employees of B Ltd. in exchange for getting power equivalent to 20,000 units. A Ltd. normally charges ₹ 0.50 per minute and B Ltd. charges ₹ 2.5 per unit. How should revenue be measured in this case?

3. Company X enters into an agreement on 1st January, 20X1 with a customer for renovation of hospital and install new air-conditioners for total consideration of ₹ 50,00,000. The promised renovation service, including the installation of new air-conditioners is a single performance obligation satisfied over time. Total expected costs are ₹ 40,00,000 including ₹ 10,00,000 for the air conditioners.

   Company X determines that it acts as a principal in accordance with paragraphs B34-B38 of Ind AS 115 because it obtains control of the air conditioners before they are transferred to the customer. The customer obtains control of the air conditioners when they are delivered to the hospital premises.

   Company X uses an input method based on costs incurred to measure its progress towards complete satisfaction of the performance obligation.

   As at 31st March, 20X1, other costs incurred excluding the air conditioners are ₹ 6,00,000.

   Whether Company X should include cost of the air conditioners in measure of its progress of performance obligation? How should revenue be recognised for the year ended March 20X1?

Answers

1. Paragraph 5(d) of Ind AS 115 excludes non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. For example, this Standard would not apply to a contract between two oil companies that agree to an exchange of oil to fulfil demand from their customers in different specified locations on a timely basis.

   In industries with homogenous products, it is common for entities in the same line of business to exchange products in order to sell them to customers or potential customers other than parties to exchange. The current scenario, on the contrary, will be covered under Ind AS 115 since the same is exchange of dissimilar goods or services because both of the entities deal in different mode of media, i.e., one is print media and another is electronic media and both parties are acting as customers and suppliers for each other.

Further, in the current scenario, it seems it is for consumption by the said parties and hence it does not fall under paragraph 5(d). It may also be noted that, even if it was to facilitate sales to customers or potential customers, it would not be scoped out since the parties are not in the same line of business.

As per paragraph 47 of Ind AS 115, “An entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both”.

Paragraph 66 of Ind AS 115 provides that to determine the transaction price for contracts in which a customer promises consideration in a form other than cash, an entity shall measure the non-cash consideration (or promise of non-cash consideration) at fair value.

In accordance with the above, Q TV and Deshabandhu should measure the revenue promised in the form of non-cash consideration as per the above referred principles of Ind AS 115.

2. Paragraph 5(d) of Ind AS 115 excludes non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. For example, this Standard would not apply to a contract between two oil companies that agree to an exchange of oil to fulfil demand from their customers in different specified locations on a timely basis.

However, the current scenario will be covered under Ind AS 115 since the same is exchange of dissimilar goods or services.

As per paragraph 47 of Ind AS 115, “an entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both”.

Paragraph 66 of Ind AS 115 provides that to determine the transaction price for contracts in which a customer promises consideration in a form other than cash, an entity shall measure the non-cash consideration (or promise of noncash consideration) at fair value.

On the basis of the above, revenue recognised by A Ltd. will be the consideration in the form of power units that it expects to be entitled for talktime sold, i.e. ₹ 50,000 (20,000 units x ₹ 2.5). The revenue recognised by B Ltd. will be the consideration in the form of talk time that it expects to be entitled for the power units sold, i.e., ₹ 50,000 (1,00,000 minutes x ₹ 0.50).

3. Paragraph B19 of Ind AS 115 inter alia, states that, "an entity shall exclude from an input method the effects of any inputs that, in accordance with the objective of measuring progress in paragraph 39, do not depict the entity's performance in transferring control of goods or services to the customer".

In accordance with the above, Company X assesses whether the costs incurred to procure the air conditioners are proportionate to the entity's progress in satisfying the performance obligation. The costs incurred to procure the air conditioners (₹ 10,00,000) are significant relative to the total costs to completely satisfy the performance obligation (₹ 40,00,000). Also, Company X is not involved in manufacturing or designing the air conditioners.

Company X concludes that including the costs to procure the air conditioners in the measure of progress would overstate the extent of the entity's performance. Consequently, in accordance with paragraph B19 of Ind AS 115, the entity adjusts its measure of progress to exclude the costs to procure the air conditioners from the measure of costs incurred and from the transaction price. The entity recognises revenue for the transfer of the air conditioners at an amount equal to the costs to procure the air conditioners (i.e., at a zero margin).

Company X assesses that as at March, 20X1, the performance is 20 per cent complete (i.e., ₹ 6,00,000 / ₹ 30,00,000). Consequently, Company X recognises the following-

As at 31st March, 20X1

	Amount in ₹
Revenue	18,00,000
Cost of goods sold	16,00,000
Profit	2,00,000

Revenue recognised is calculated as (20 per cent × ₹ 40,00,000) + ₹ 10,00,000.

(₹ 40,00,000 = ₹ 50,00,000 transaction price – ₹ 10,00,000 costs of air conditioners.)

Cost of goods sold is ₹ 6,00,000 of costs incurred + ₹ 10,00,000 costs of air conditioners.

CHAPTER 4

IND AS ON MEASUREMENT BASED ON ACCOUNTING POLICIES

UNIT 1: INDIAN ACCOUNTING STANDARD 8 : ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Employ the principles laid down for selection of accounting policies.
- Explain the treatment of changes in accounting policies, changes in accounting estimates and correction of prior period errors.
- Distinguish between accounting policies, estimates, changes in them and errors.
- Assess the limitations of giving retrospective effect while accounting.
- Judge the impracticability of a requirement for giving retrospective effect.

UNIT OVERVIEW

Ind AS 8 "Accounting Policies, Changes in Accounting Estimates and Errors"

Accounting Policies

- Selection and application of accounting policies
- Consistency of accounting policies
- Changes in accounting policies
- Applying changes in accounting policies
  - Retrospective application
  - Limitations on retrospective application
- Disclosure

Changes in Accounting Estimates

- Apply changes in accounting estimates prospectively

Errors

- Limitations on retrospective restatement
- Disclosure of prior period errors

1.1 INTRODUCTION

Ind AS 1, Presentation of Financial Statements, lays down the foundation for an entity regarding how the financial statements need to be presented. Ind AS 1 gives equal importance to the disclosure, in notes, of significant accounting policies and other explanatory information besides balance sheet, statement of profit and loss and statement of cash flows.

Accounting policies, estimates and correction of errors play a major role in the presentation of financial statements. That is why Ind AS 1 states that an entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material. If there is any change in accounting policies, that needs to be dealt with due diligence and not just by mere note or explanation.

Further, Ind AS 1 makes it compulsory for the entity to present a third balance sheet as at the beginning of the preceding period, if it applies an accounting policy retrospectively, which has a material effect on the information in the balance sheet at that date.

Further, Ind AS 1 provides detail guidance about the proper disclosure of accounting policies and estimates.

Therefore, in the current chapter we are going to see, how to select the accounting policies, how to make the changes in accounting policies if needed, how to deal with changes in the estimates, how to rectify errors, etc., as all these elements will have impact on the true and fair position of the financial statements.

1.2 OBJECTIVE

1.2.1 To prescribe the criteria for selecting and changing accounting policies

As per Ind AS 1, an entity is required to disclose the significant accounting policies. However, it does not specify which accounting policies are to be disclosed. Depending upon the nature of business and types of transactions, the entity is supposed to decide whether an accounting policy is to be disclosed. In this regard, Ind AS 1 lays emphasis on usefulness of the disclosure in assisting the users in understanding financial statements, nature of an entity's operations and expectations of users. Ind AS 8 further provides some criteria / guidelines which will facilitate the entity to take a decision on selection and application of accounting policies and also making changes in them.

1.2.2 To prescribe the accounting treatment and disclosure of changes in accounting policies

At certain times, there is a need to make the changes in the policies in the light of changing circumstances of business, changing nature of business, new guidelines issued by regulatory authorities, enforcement of new laws etc. In such cases, an entity needs guidance as to whether the changes need to be effected retrospectively or only prospectively and how to present and disclose the effect of the same etc. Ind AS 8 provides guidance to the entity in such areas.

1.2.3 To prescribe the accounting treatment and disclosure of changes in accounting estimates

In business, there are many future things which are uncertain. For example, how many debtors will turn bad? What will be the estimated life of a fixed asset? What will be the value of investments? Will the net realisable value of closing inventory be more or less than the actual realised value less actual costs of completion and actual costs necessary to make the sale? And so on. In such cases, the entity will have to make few assumptions and make an estimate. Ind AS 1 allows an entity to do the estimation. Ind AS 8 takes it further and deals with how to incorporate the changes in the accounting estimates already made in the past. Is it possible to change such estimates with changing circumstances and available new information? If yes, how would the entity incorporate the effect of the changes? Such questions are addressed in Ind AS 8.

1.2.4 To prescribe the accounting treatment and disclosure of corrections of errors

It is said that 'to err is human'. Making mistakes is an integral part of life and the possibility of having some errors in the financial statements already published cannot be ruled out. In such cases, the question arises as to how to rectify the errors and provide the true and fair position to the stakeholders for future. Should the entity rectify the error by way of retrospective restatement or should it rectify the same in the current reporting period? Such questions are addressed in Ind AS 8.

1.2.5 To provide better base for inter-firm and intra-firm comparison

The standard is intended to enhance the relevance and reliability of an entity's financial statements and the comparability of those financial statements over time and with the financial statements of other entities.

1.3 SCOPE

This standard shall be applied in

- selecting and applying accounting policies;
- accounting for changes in accounting policies;
- accounting for changes in accounting estimates; and
- accounting for corrections of prior period errors.

However, tax effects of retrospective application of accounting policy changes and correction of prior period errors are not dealt with in this standard. The tax effects of these items are dealt with Ind AS 12, 'Income Taxes'.

Note: Requirements of Ind AS 8 in respect of changes in accounting policies do not apply in an entity's first Ind AS financial statements.

1.4 DEFINITIONS

1. ***Accounting policies*** are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

2. A ***change in accounting estimate*** is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

3. ***Indian Accounting Standards (Ind ASs)*** are Standards prescribed under Section 133 of the Companies Act, 2013.

4. ***Material Omissions or misstatements*** of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

   Assessing whether an omission or misstatement could influence economic decisions of users, and so be material, requires consideration of the characteristics of those users. The *Framework for the Preparation and Presentation of Financial Statements in accordance with Indian Accounting Standards* issued by the Institute of Chartered Accountants of India states that 'users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.' Therefore, the assessment needs to take into account how users with such attributes could reasonably be expected to be influenced in making economic decisions.

5. ***Prior period errors*** are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

   (a) was available when financial statements for those periods were approved for issue; and

   (b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

6. ***Retrospective application*** is applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.

7. ***Retrospective restatement*** is correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred.

8. ***Impracticable:*** Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:

(a) the effects of the retrospective application or retrospective restatement are not determinable;

(b) the retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period; or

(c) the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:

(i) provides evidence of circumstances that existed on the date(s)as at which those amounts are to be recognised, measured or disclosed; and

(ii) would have been available when the financial statements for that prior period were approved for issue from other information.

9. ***Prospective application*** of a change in accounting policy and of recognising the effect of a change in an accounting estimate, respectively, are:

(a) applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed; and

(b) recognising the effect of the change in the accounting estimate in the current and future periods affected by the change.

1.5 ACCOUNTING POLICIES

1.5.1 Selection and Application of Accounting Policies

When an Ind AS specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item shall be determined by applying the Ind AS.

Ind AS 1 narrates the importance of accounting policies but Ind AS 8 goes a step further and gives guidance to the entity as to how to select and apply accounting policies.

Let us take few examples of accounting policies:

(a) Basis of accounting – Cash or accrual or hybrid?

(b) Method of determination of cost of inventories – FIFO or specific identification or Weighted Average?

(c) What is included in cash equivalents and what is excluded from cash equivalents?

(d) When should revenue be recognised?

Thus, one will notice that while preparing the financial statements, the entity has to make numerous assumptions and define the base for measurement of particular transactions, other events or conditions. If every entity follows a different base or a different rule or a different convention according to their convenience/ interpretation, then it will be impossible to compare the financial statements across entities having similar nature of business. Therefore, the role of Ind AS is very important in selection and application of the policies.

As per Ind AS 8, if any of the Ind AS already specifies the guidelines about following a particular policy then entity **must** follow that standard and apply the policy as per the guidance provided. Moreover, an entity can also refer to guidance notes which are published by ICAI, along with the relevant Ind AS, if there is an ambiguity or there is need to go into the depth of a particular transaction.

1.5.2 Is it Compulsory to apply accounting policies?

- Ind AS set out accounting policies that result in financial statements containing relevant and reliable information about the transactions, other events and conditions to which they apply.
- Those policies need not be applied when the effect of applying them is immaterial.
- However, it is inappropriate to make, or leave uncorrected, immaterial departures from Ind AS to achieve a particular presentation of an entity's financial position, financial performance or cash flows.

Analysis

Ind AS leaves the judgement to the entity to decide whether it would be material or not material to apply any accounting policy. Users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. Therefore, the assessment needs to take into account how users with such attributes could reasonably be expected to be influenced in making economic decisions.

1.5.3 How to select and apply an accounting policy when specific Ind AS is not available on the particular transaction/condition/event?

- In the absence of an Ind AS that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is:

  (a) relevant to the economic decision-making needs of users; and

  (b) reliable in that the financial statements:

    (i) represent faithfully the financial position, financial performance and cash flows of the entity;

    (ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;

(iii) are neutral, i.e. free from bias;

(iv) are prudent; and

(v) are complete in all material respects.

Analysis

The businesses may have large variety in terms of their nature and size. Though Ind AS cover most of the transactions which are of general nature for any type of business, there is possibility of new business models coming into picture and new technologies changing the face of the business, resulting in some new and complex types of transactions. In such circumstances it will be difficult to find out the appropriate accounting standard for such specific transactions.

Example

Before the wake of online transactions of capital markets, the trading of shares used to take place mainly through brokers and stock exchanges. However, OTC online terminals changed the face of the capital markets, giving direct access to the layman to trading transactions. Even if the basic nature of business was same, the technology changes the face of the business and many giant financial institutions became the dominant players in the market as brokerage firms. In view of the changing circumstances, SEBI and ICAI had come up with new guidelines and new standards which will cater to the need of new business models, such as trading in derivatives. However, there was a period of transformation when new transactions were slowly creeping in but the guidelines were in the preparatory phase.

In such circumstances, Ind AS 8 provides the following guiding principles for selecting and applying the accounting policies. The main two objectives to be kept in mind while making the decision for selecting an accounting policy would be:

(i) **Whether it is relevant?** The basic purpose of presenting financial statements is to facilitate the economic decision making of the stakeholders, which would be based on the information provided in the financial statements. So if the management is of the opinion that an accounting policy related to a particular transaction/ condition / event results in information that is going to help the users to make the economic decisions, then the entity must select and apply such accounting policy as it is relevant for decision making.

(ii) **Whether it is reliable?** The information will be said to be reliable if it makes a faithful representation, unbiased, prudent, complete in all material respects and it reflects substance of the transaction and is not presented solely with a purpose of adhering to the law.

- In making the judgement, management shall refer to, and consider the applicability of, the following sources in descending order:

  (a) the requirements in Ind AS dealing with similar and related issues; and

(b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the *Framework*.

- Management may also first consider the most recent pronouncements of International Accounting Standards Board (IASB) and in absence thereof those of the other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices, to the extent that these do not conflict with the sources mentioned above.

Analysis

There is a need to have some authentic base for selecting and applying the accounting policy. Even if it is left to the judgement of the entity, there has to be some basis for making the judgement. It cannot be left to the personal opinions/ understanding/ intuitions of the people working for the entity. In view of this, Ind AS 8 requires that in absence of specific Ind AS, the entity should refer to the following material, in their descending order. Accordingly, Ind AS 8 provides the following list:

(i) Check if there are any other Ind AS available which are dealing with **similar and related** issues

(ii) Check the basic Framework of Ind AS, which provides the general principles

(iii) Check the pronouncements of International Accounting Standard Board

(iv) Check the pronouncements of other standard setting bodies having a similar conceptual framework

(v) Check the accounting literature and accepted industry practices.

1.5.4 Consistency of accounting policies

An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless an Ind AS specifically requires or permits categorisation of items for which different policies may be appropriate. If an Ind AS requires or permits such categorisation, an appropriate accounting policy shall be selected and applied consistently to each category.

Analysis

Accounting policies are the bases or principles or conventions or rules which are followed by an entity while preparing the financial statements. If the entity keeps on changing the base from year to year, it will not reflect the true and fair position of the entity. Secondly the results of earlier years cannot be compared with the latest years as the base of the measurement is changed. Therefore, it is utmost necessity that the entity follows the accounting policies consistently.

Example

An entity has grouped its property, plant and equipment into four classes viz., land, factory building, plant and machinery and furniture. The entity may propose to apply revaluation model only to land. It need not apply this model to building or plant and machinery.

1.5.5 Changes in accounting policies

- An entity shall change an accounting policy only if the change:

  (a) is required by an Ind AS; or

  (b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

- Users of financial statements need to be able to compare the financial statements of an entity over time to identify trends in its financial position, financial performance and cash flows. Therefore, the same accounting policies are applied within each period and from one period to the next unless a change in accounting policy meets one of the above criteria.

  Analysis

  Continuing with the same rationale, the frequent changes in accounting policies are not permitted by Ind AS 8. Frequent changes in accounting policies will make it impossible for a stakeholder to make the economic decisions properly.

  For example, suppose an entity has been following the FIFO method of determination of cost for inventories. In the current year, it shifts from FIFO to weighted average method. Assuming that cost is less than NRV, it means the opening stock is valued at FIFO method whereas closing stock is valued at Weighted Average Method, if retrospective application of the change is impracticable. This will directly impact the gross profit measurement of the entity. Additionally, the opening inventories and closing inventories will not be comparable. Moreover, if the investment companies and banks are using the information for calculation of liquidity, then, the liquidity ratios based on opening inventory and closing inventory may show major discrepancies. Thus, changing the base will not only affect the true and fair position of the financial statements but it will also affect the decision making of the stakeholders.

  In view of the above, Ind AS 8 allows the entity to change the accounting policy only in following circumstances:

  (a) when the change is required by an Ind AS; or

  (b) when the change results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

- The following are not changes in accounting policies:

  (a) the application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring; and

  (b) the application of a new accounting policy for transactions, other events or conditions that did not occur previously or were immaterial.

  Analysis

  Ind AS 8 clearly states that if the entity applies an accounting policy which is different from the previous one to a transaction, other event or condition that differs in substance from a previously occurring transaction, other event or condition, the application of the new policy will not be considered as a change in accounting policy.

  Example

  A company owns several hotels and provides significant ancillary services to occupants of rooms. These hotels are, therefore, treated as owner-occupied properties and classified as property, plant and equipment in accordance with Ind AS 16. The company acquires a new hotel but outsources entire management of the same to an outside agency and remains as a passive investor. The selection and application of an accounting policy for this new hotel in line with Ind AS 40 is not a change in accounting policy simply because the new hotel rooms are also let out for rent. This is because the way in which the new hotel is managed differs in substance from the way other existing hotels have been managed so far.

  Similarly, if an entity is not applying the accounting policy currently and starts applying the accounting policy newly, that will also not be treated as change in accounting policy.

  Example

  An entity has classified as investment property, an owner occupied property previously classified as part of property, plant and equipment where it was measured after initial recognition applying the revaluation model. Ind AS 40 on investment property permits only cost model. The entity now measures this investment property using the cost model. This is not a change in accounting policy.

- The initial application of a policy to revalue assets in accordance with Ind AS 16, Property, Plant and Equipment, or Ind AS 38, Intangible Assets, is a change in an accounting policy to be dealt with as a revaluation in accordance with Ind AS 16 or Ind AS 38, rather than in accordance with Ind AS 8.

- As per Ind AS 16, a change in depreciation method should be accounted for as a change in accounting estimate in accordance with Ind AS 8. Similarly, as per Ind AS 38, a change in amortisation method should be accounted for as a change in accounting estimate in accordance with Ind AS 8. These changes are, therefore, not changes in accounting policies.

Illustration 1

Can an entity voluntarily change one or more of its accounting policies?

Solution

A change in an accounting policy can be made only if the change is required or permitted by Ind AS 8.

As per para 14 of Ind AS 8, an entity shall change an accounting policy only if the change:

(a) is required by an Ind AS; or

(b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

Para 15 of the standard states that the users of financial statements need to be able to compare the financial statements of an entity over time to identify trends in its financial position, financial performance and cash flows. Therefore, the same accounting policies are applied within each period and from one period to the next unless a change in accounting policy meets one of the above criteria.

Paragraph 14(b) lays down two requirements that must be complied with in order to make a voluntary change in an accounting policy. First, the information resulting from application of the changed (i.e., the new) accounting policy must be reliable. Second, the changed accounting policy must result in "more relevant" information being presented in the financial statements.

Whether a changed accounting policy results in reliable and more relevant financial information is a matter of assessment in the particular facts and circumstances of each case. In order to ensure that such an assessment is made judiciously (such that a voluntary change in an accounting policy does not effectively become a matter of free choice), paragraph 29 of Ind AS 8 requires an entity making a voluntary change in an accounting policy to disclose, inter alia, "the reasons why applying the new accounting policy provides reliable and more relevant information."

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Illustration 2

Entity ABC acquired a building for its administrative purposes and presented the same as property, plant and equipment (PPE) in the financial year 20X1- X2. During the financial year 20X2- X3, it relocated the office to a new building and leased the said building to a third party. Following the change in the usage of the building, Entity ABC reclassified it from PPE to investment property in the financial year 20X2- X3. Should Entity ABC account for the change as a change in accounting policy?

Solution

Paragraph 16(a) of Ind AS 8 provides that the application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring are not changes in accounting policies.

As per Ind AS 16, 'property, plant and equipment' are tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than one period."

As per Ind AS 40, 'investment property' is property (land or a building—or part of a building—or both) held (by the owner or by the lessee as a right-of-use asset) to earn rentals or for capital appreciation or both, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes; or

(b) sale in the ordinary course of business."

As per the above definitions, whether a building is an item of property, plant and equipment (PPE) or an investment property for an entity depends on the purpose for which it is held by the entity. It is thus possible that due to a change in the purpose for which it is held, a building that was previously classified as an item of property, plant and equipment may warrant reclassification as an investment property, or vice versa. Whether a building is in the nature of PPE or investment property is determined by applying the definitions of these terms from the perspective of that entity. Thus, the classification of a building as an item of property, plant and equipment or as an investment property is not a matter of an accounting policy choice. Accordingly, a change in classification of a building from property, plant and equipment to investment property due to change in the purpose for which it is held by the entity is **not** a change in an accounting policy.

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Illustration 3

Whether change in functional currency of an entity represents a change in accounting policy?

Solution

Paragraph 16(a) of Ind AS 8 provides that the application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring are not changes in accounting policies.

As per Ind AS 21, 'functional currency' is the currency of the primary economic environment in which the entity operates.

Paragraphs 9-12 of Ind AS 21 list factors to be considered by an entity in determining its functional currency. It is recognised that there may be cases where the functional currency is not obvious. In such cases, Ind AS 21 requires the management to use its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions.

Paragraph 13 of Ind AS 21 specifically notes that an entity's functional currency reflects the underlying transactions, events and conditions that are relevant to it. Accordingly, once determined, the functional currency is not changed unless there is a change in those underlying transactions, events and conditions. Thus, functional currency of an entity is not a matter of an accounting policy choice.

In view of the above, a change in functional currency of an entity does not represent a change in accounting policy and Ind AS 8, therefore, does not apply to such a change. Ind AS 21 requires that when there is a change in an entity's functional currency, the entity shall apply the translation procedures applicable to the new functional currency prospectively from the date of the change.

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1.5.5.1 How to apply the changes in accounting policies?

While discussing the process for application of changes of accounting policies, Ind AS 8, deals with two situations:

1. an entity shall account for a change in accounting policy resulting from the initial application of an Ind AS in accordance with the specific transitional provisions, if any, in that Ind AS.

   If a change in accounting policy is due to a new Ind AS, then, generally the standard itself will provide the transitional provisions i.e., provisions applicable on initial application of the standard, such as method of application (retrospective or prospective or modified retrospective), availability of any transitional relief etc. In such cases, the entity needs to follow the transitional provisions accordingly.

2. when an entity changes an accounting policy upon initial application of an Ind AS that does not include specific transitional provisions applying to that change, or changes an accounting policy voluntarily, it shall apply the change retrospectively.

   If the change in accounting policy is made voluntarily or where the Ind AS is not containing transitional provisions, then the accounting policy needs to be applied retrospectively.

Note: Early application of an Ind AS is not a voluntary change in accounting policy.

In the absence of an Ind AS that specifically applies to a transaction, other event or condition, management may apply an accounting policy from the most recent pronouncements of IASB and in absence thereof those of the other standard-setting bodies that use a similar conceptual framework to develop accounting standards.

If, following an amendment of such a pronouncement, the entity chooses to change an accounting policy, that change is accounted for and disclosed as a voluntary change in accounting policy.

Suppose in absence of any specific Ind AS to a particular transaction, a company follows an accounting policy as per the relevant IFRS which addresses that transaction and, subsequently there is an amendment to that IFRS, then, the company may change its accounting policy as per that amendment. In such cases, it will be considered as if the company is making the change voluntarily and, accordingly, change in the accounting policy should be applied retrospectively.

Illustration 4

An entity developed one of its accounting policies by considering a pronouncement of an overseas national standard-setting body in due accordance with Ind AS 8. Would it be permissible for the entity to change the said policy to reflect a subsequent amendment in that pronouncement?

Solution

In the absence of an Ind AS that specifically applies to a transaction, other event or condition, management may apply an accounting policy from the most recent pronouncements of International Accounting Standards Board and in absence thereof those of the other standard-setting bodies that use a similar conceptual framework to develop accounting standards. If, following an amendment of such a pronouncement, the entity chooses to change an accounting policy, that change is accounted for and disclosed as a voluntary change in accounting policy. As such a change is a voluntary change in accounting policy, it can be made only if it results in information that is reliable and more relevant (and does not conflict with the sources in Ind AS 8).

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1.5.5.2 Retrospective application

When a change in accounting policy is applied retrospectively, the entity shall adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.

Analysis

The word retrospective application is defined in Ind AS 8 as applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied. This means that comparative information for all prior periods presented will be adjusted for the effect of change in the policy. The amount of the resulting adjustment relating to periods before those presented in the financial statements is made to the opening balance of each affected component of equity of the earliest prior period presented. Usually the adjustment is made to retained earnings. However, the adjustment may be made to another component of equity (for example, to comply with an Ind AS).

Example

An entity which is trading in goods (and not a manufacturer) was incorporated in the year 20X1-20X2 and is a regular user of Ind AS from that year. It has been using weighted average cost formula for determining cost of inventories. In 20X8-20X9, it decides to change the above accounting policy. It wants to use FIFO cost formula. The change in the policy is justified because that formula reflects the actual flow of inventories and, hence, provides reliable and more relevant information to the users of financial statements. The entity presents one year comparative period in its financial statements. Its purchase bills include freight etc., and quantities of inventories as on 1st April, 20X7 and 31st March, 20X8 are such that latest invoices for the relevant years can be attributed to them. Further, other purchase incidental expenses are immaterial. Due to these reasons, retrospective application of change in accounting policy is practicable.

Before deciding on method of application of change in accounting policy, one point should be noted. Since the entity trades in goods, both purchases of stock-in-trade and increase/decrease in inventories of stock-in-trade will appear in the statement of profit and loss. This is because Ind AS 1 permits nature-wise presentation only, which is also the position in Schedule III to the Companies Act, 2013. The change in accounting policy, however, will affect only the carrying amount of inventories and consequently, increase/decrease in inventories, if cost is below NRV, but will not affect amount of purchases.

In the above situation, the entity should apply the change in the accounting policy retrospectively. For this purpose, the entity should recalculate inventory value at the lower of cost determined on FIFO basis and NRV as at 1st April, 20X7 and 31st March, 20X8. The difference between previously presented opening inventory value as at 1st April, 20X7 (which would have been presented in the closing balance sheet as at 31st March, 20X7) and the recalculated value as on that date as above is the cumulative effect of change in accounting policy on the opening balance sheet for the comparative year 20X7-20X8. The difference between previously presented closing inventory value as at 31st March, 20X8 and the recalculated value as on that date as above is the cumulative effect of change in accounting policy on the closing balance sheet for the comparative year 20X7-20X8. The difference between the cumulative effects on the opening and closing balance sheets for the comparative year 20X7-20X8 as arrived at above is the period-specific effect of change in the policy for that comparative year. Accordingly, while preparing the financial statements for the year 20X8-20X9, the entity should adjust the opening inventory as at 1st April, 20X7 and adjust retained earnings on that date for the cumulative effect of change in accounting policy and restate comparative amount in respect of increase/decrease in inventories in the statement of profit and loss for the comparative year 20X7-20X8. This results in consequential restatement of profit or loss, total comprehensive income, closing balances of retained earnings and inventories for that comparative year. The said restated closing balances of retained earnings and inventories become opening balances of these items for the year 20X8-20X9, which is the year of change in accounting policy. Income tax effect due to change in accounting policy will be accounted for in accordance with Ind AS 12.

1.5.5.3 Limitations on retrospective application

- The intention of the standard is, as far as possible, that the companies should follow the same accounting policies consistently year after year to ensure the relevance and reliability of financial statements.
- There are some advantages of making the process of change in accounting policy so tedious as outlined below.
    i. Companies will not make the frequent changes in their accounting policies just to do the window dressing of their financial statements.

ii. The comparison of financial statements over the time and over the industry will be possible, in a reliable way.

- Having said this, there can be practical difficulties in making the retrospective changes in policies, when the company wants to change the policy.

Example

A company has been established 25 years ago. Now, is it supposed to incorporate the changes in accounting policy for last 25 years? Will it be practicable? Will it be worth doing it? Will it be material? Such questions arise when one wants to change the accounting policy, since, voluntary change in policy is required to be applied retrospectively.

- When retrospective application is required, a change in accounting policy shall be applied retrospectively except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the change.
- The term 'Impracticability' is defined under Ind AS 8 as follows:

  Impracticable - Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:

  (a) the effects of the retrospective application or retrospective restatement are not determinable;

  (b) the retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period; or

  (c) the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:

  (i) provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed; and

  (ii) would have been available when the financial statements for that prior period were approved for issue from other information.

- After going through the above mentioned definition of impractical, it is clear that the Ind AS 8 does provide some relief if there are practical difficulties in applying the policy retrospectively.
- Ind AS 8 talks about two types of effects which one need to understand:

  i. Period Specific: Period specific means for each financial year.

  ii. Cumulative: Cumulative is the sum total of the period specific effects.

- When it is impracticable to determine the period-specific effects of changing an accounting policy on comparative information for one or more prior periods presented, then the entity shall apply the new accounting policy to the carrying amounts of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable, which may be the current period, and shall make a corresponding adjustment to the opening balance of each affected component of equity for that period.
- Thus, if it is impracticable for an entity to change the policy from day 1, because it is impracticable to determine period-specific effects for one or more comparative prior periods presented, it can apply the changed policy from the earliest period for which it would be practicable to make the changes in policies retrospectively which may be the current period.

Example

In the example given in section 1.5.5.2, if comparative information is presented for two years i.e., 20X6-20X7 and 20X7-20X8 and if it is not practicable to apply the changed policy retrospectively from 20X6-20X7, then, the entity can apply the changed policy retrospectively from 20X7-20X8. This may happen if it is not practicable to compute inventory value in accordance with the changed policy as on 1st April, 20X6, for example, due to loss of latest purchase bills for the year 20X5-20X6 and computer records of the same are also lost.

In the above example, if comparative information is presented for one year and if it is not practicable to compute the opening inventory value as at 1st April, 20X7, the entity can apply the changed policy retrospectively from 20X8-20X9.

- When an entity applies a new accounting policy retrospectively, it applies the new accounting policy to comparative information for prior periods as far back as is practicable. Retrospective application to a prior period is not practicable unless it is practicable to determine the cumulative effect on the amounts in both the opening and closing balance sheets for that period. The amount of the resulting adjustment relating to periods before those presented in the financial statements is made to the opening balance of each affected component of equity of the earliest prior period presented. Usually the adjustment is made to retained earnings. However, the adjustment may be made to another component of equity (for example, to comply with an Ind AS). Any other information about prior periods, such as historical summaries of financial data, is also adjusted as far back as is practicable.
- When it is impracticable to determine the cumulative effect, at the beginning of the current period, of applying a new accounting policy to all prior periods, the entity shall adjust the comparative information to apply the new accounting policy prospectively from the earliest date practicable. It therefore disregards the portion of the cumulative adjustment to assets, liabilities and equity arising before that date. Changing an accounting policy is permitted even if it is impracticable to apply the policy prospectively for any prior period.

Example

An entity changes in 20X6 its accounting policy with respect to determination of cost of its inventories from FIFO to weighted average cost formula. This change is made because management believes that weighted average cost formula results in better matching of cost with revenue. Further, weighted average cost formula is generally used by other entities whose business is similar to that of the entity and, hence, provides reliable and more relevant information to the users of the financial statements. This being a voluntary change, it has to be applied retrospectively. The entity had commenced operations in 20X1. No records of earlier years are available as a virus attack on server in 20X6 had wiped off all past records. It is not possible to recreate the records. It is therefore impracticable to determine the cumulative effect of change in policy at the beginning of 20X6. The entity will apply the change in accounting policy prospectively from 20X6 only. Since the change in policy is applied prospectively from 20X6, the question of adjusting comparative information for any prior period(s) presented does not arise at all. Cost of closing inventories for 20X6 alone will be determined using weighted average cost formula. The carrying amount of closing inventories for 20X5 will simply be carried as carrying amount of opening inventories for 20X6. Cost of closing inventories for 20X5 determined on FIFO basis will be the starting point for applying weighted average cost formula during 20X6.

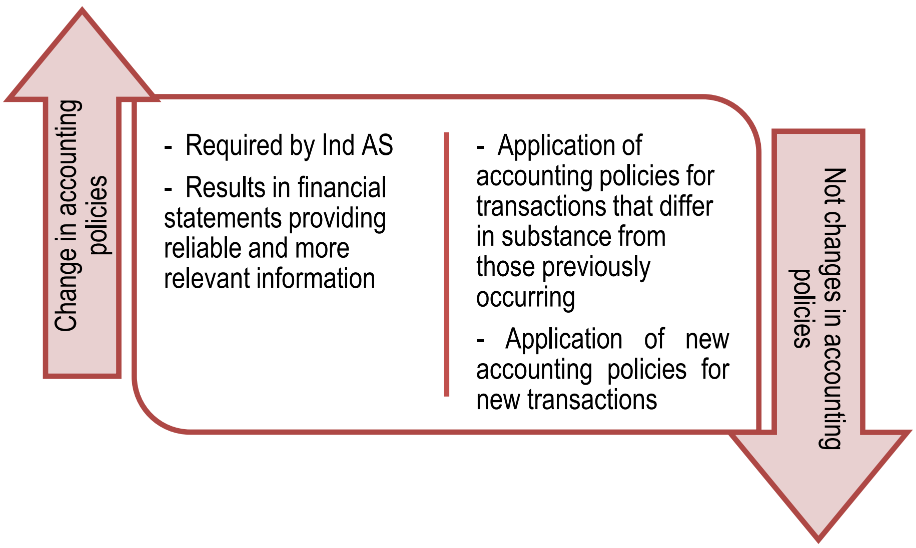

Illustration 5

Whether an entity can change its accounting policy of subsequent measurement of property, plant and equipment (PPE) from revaluation model to cost model?

Solution

Paragraph 29 of Ind AS 16 provides that an entity shall choose either the cost model or the revaluation model as its accounting policy for subsequent measurement of an entire class of PPE.

A change from revaluation model to cost model for a class of PPE can be made only if it meets the condition specified in Ind AS 8 paragraph 14(b) i.e. the change results in the financial statements providing reliable and more relevant information to the users of financial statements. For example, an unlisted entity planning IPO may change its accounting policy from revaluation model to cost model for some or all classes of PPE to align the entity's accounting policy with that of listed markets participants within that industry so as to enhance the comparability of its financial statements with those of other listed market participants within the industry. Such a change – from revaluation model to cost model is not expected to be frequent.

Where the change in accounting policy from revaluation model to cost model is considered permissible in accordance with Ind AS 8 paragraph 14(b), it shall be accounted for retrospectively, in accordance with Ind AS 8.

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1.5.6 Disclosure regarding the Changes in Accounting Policies

- When initial application of an Ind AS has an effect on the current period or any prior period, would have such an effect except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods, an entity shall disclose:

  (a) the title of the Ind AS;

  (b) when applicable, that the change in accounting policy is made in accordance with its transitional provisions;

  (c) the nature of the change in accounting policy;

  (d) when applicable, a description of the transitional provisions;

  (e) when applicable, the transitional provisions that might have an effect on future periods;

  (f) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:

    (i) for each financial statement line item affected; and

    (ii) if Ind AS 33, 'Earnings per Share', applies to the entity, for basic and diluted earnings per share;

  (g) the amount of the adjustment relating to periods before those presented, to the extent practicable; and

  (h) if retrospective application required by paragraph 19(a) or (b) is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

- When a voluntary change in accounting policy has an effect on the current period or any prior period, would have an effect on that period except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods, an entity shall disclose:

  (a) the nature of the change in accounting policy;

  (b) the reasons why applying the new accounting policy provides reliable and more relevant information;

  (c) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:

    (i) for each financial statement line item affected; and

    (ii) if Ind AS 33 applies to the entity, for basic and diluted earnings per share;

  (d) the amount of the adjustment relating to periods before those presented, to the extent practicable; and

  (e) if retrospective application is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

Note:

- Financial statements of subsequent periods need not repeat these disclosures.
- The disclosures will be part of Notes.

- When an entity has not applied a new Ind AS that has been issued but is not yet effective, the entity shall disclose:

  (a) this fact; and

  (b) known or reasonably estimable information relevant to assessing the possible impact that application of the new Ind AS will have on the entity's financial statements in the period of initial application.

- In complying with the above requirement, an entity considers disclosing:

  (a) the title of the new Ind AS;

  (b) the nature of the impending change or changes in accounting policy;

  (c) the date by which application of the Ind AS is required;

  (d) the date as at which it plans to apply the Ind AS initially;

(e) either:

  (i) a discussion of the impact that initial application of the Ind AS is expected to have on the entity's financial statements; or

  (ii) if that impact is not known or reasonably estimable, a statement to that effect.

Illustration 6

Whether an entity is required to disclose the impact of any new Ind AS which is issued but not yet effective in its financial statements as prepared as per Ind AS?

Solution

Paragraph 30 of Ind AS 8 Accounting Policies, Changes in Accounting Estimates and Errors, states as follows:

"When an entity has not applied a new Ind AS that has been issued but is not yet effective, the entity shall disclose:

(a) this fact; and

(b) known or reasonably estimable information relevant to assessing the possible impact that application of the new Ind AS will have on the entity's financial statements in the period of initial application."

Accordingly, it may be noted that an entity is required to disclose the impact of Ind AS which has been issued but is not yet effective.

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1.6 CHANGE IN ACCOUNTING ESTIMATES

1.6.1 Meaning

- As a result of the uncertainties inherent in business activities, many items in financial statements cannot be measured with precision but can only be estimated. Estimation involves judgements based on the latest available, reliable information. For example, estimates may be required of:
  - bad debts;
  - inventory obsolescence;
  - the fair value of financial assets or financial liabilities;
  - the useful lives of, or expected pattern of consumption of the future economic benefits embodied in, depreciable assets; and
  - warranty obligations.

- The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

1.6.2 Can changes in estimates be related to prior periods?

An estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience. By its nature, the revision of an estimate does not relate to prior periods and is not the correction of an error.

1.6.3 Change in the basis of measurement – Whether a change in accounting policy or change in estimate?

A change in the measurement basis applied is a change in an accounting policy, and is not a change in an accounting estimate. When it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in an accounting estimate.

Illustration 7

Whether a change in inventory cost formula is a change in accounting policy or a change in accounting estimate?

Solution

As per Ind AS 8, accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements. Further, paragraph 36(a) of Ind AS 2, 'Inventories', specifically requires disclosure of 'cost formula used' as a part of disclosure of accounting policies adopted in measurement of inventories.

Accordingly, a change in cost formula is a change in accounting policy.

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1.6.4 Accounting treatment for a change in estimate

- The effect of change in an accounting estimate, except to the extent that the change results in change in assets, liabilities or equity, shall be recognised prospectively by including it in profit or loss in:

  (a) the period of the change, if the change affects that period only; or

  (b) the period of the change and future periods, if the change affects both.

  A change in an accounting estimate may affect only the current period's profit or loss, or the profit or loss of both the current period and future periods.

- To the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it shall be recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.

- Prospective recognition of the effect of a change in an accounting estimate means that the change is applied to transactions, other events and conditions from the date of the change in estimate.

Example

A change in the estimate of the amount of bad debts affects only the current period's profit or loss and therefore is recognised in the current period. However, a change in the estimated useful life of, or the expected pattern of consumption of the future economic benefits embodied in, a depreciable asset affects depreciation expense for the current period and for each future period during the asset's remaining useful life. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods is recognised as income or expense in those future periods.

Example

During the financial year ended 31st March, 20X2, Entity ABC introduced a new range of electric motors. It sold the motors with a standard warranty of two years. Warranty provides assurance that a product will function as expected and in accordance with certain specifications and it has been assessed that it is not a separate performance obligation under Ind AS 115.

Based on results of testing of the motors during trials prior to commercial production, Entity ABC made a provision for warranty costs amounting to ₹ 1,00,000 for motors sold during the year ended 31st March, 20X2.

During financial year 20X2-X3, a defect was discovered in the motors that had not come to light during the trials. The defect resulted in the entity incurring an amount of ₹ 2,00,000 during the financial year 20X2-X3 on repairs of motors sold during the financial year 20X1-X2. Besides, the entity expects to incur ₹ 1,50,000 as costs during the year 20X3-X4 on meeting its warranty obligations in respect of motors sold during the financial year 20X2- X3.

In preparing its financial statements for the year ended 31st March, 20X3, the entity would carry forward a warranty provision of ₹ 1,50,000 in respect of motors sold during the financial year 20X1-X2. It would recognise an amount of ₹ 2,50,000 (₹ 2,00,00 plus ₹ 1,50,000 minus ₹ 1,00,000) in respect of motors sold during the financial year 20X1-X2 as an expense in profit or loss for the financial year 20X2-X3. The warranty provision included in the comparatives for financial year ended 31st March, 20X2 would not be adjusted.

The provision for warranty costs in respect of motors sold during the financial year 20X2-X3 would be made by considering the information concerning the defect in motors that came to light during the financial year.

1.6.5 Disclosure of changes in estimates

- An entity shall disclose the nature and amount of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods, except for the disclosure of the effect on future periods when it is impracticable to estimate that effect.
- If the amount of the effect in future periods is not disclosed because estimating it is impracticable, an entity shall disclose that fact.

Thus, to summarise the above mentioned provisions, the entity should disclose:

i. Effect of change in estimate on the current period

ii. If applicable and practicable, effect of change in estimate on the future periods

iii. If applicable but impracticable, the fact that it is impracticable to estimate the effect on future periods.

1.7 ERRORS

1.7.1 Meaning

- Ind AS 8 deals with the treatment of errors that have taken place in past, but were not revealed at that time. Subsequently, when they are revealed, it is necessary to correct such errors in the financial statements and make sure that the financial statements present relevant and reliable information in the period in which they are revealed.

  As per the definition given in Ind AS 8, ***Prior period errors*** are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

  (a) was available when financial statements for those periods were approved for issue; and

  (b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

- Errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not comply with Ind AS if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows.

1.7.2 Common types of Errors

(i) **Mathematical Mistakes:** In accounting terms, generally the errors are called as error of commission. Wrong calculations, carry forward of wrong balances and errors in totals are few examples of mathematical errors.

(ii) **Mistakes in applying policies:** Specific standards may prescribe method of applying specific policies for particular nature of transaction. For example, as a general rule, assets and liabilities and income and expenses should not be offset, unless otherwise specifically required or permitted in an Ind AS. If a receivable from another entity and payable to that entity are offset without any currently existing legally enforceable right to set off the recognised amounts, then, it will be an error while applying the policies, since it is against the principles of offset prescribed in Ind AS 32, 'Financial Instruments: Presentation'.

(iii) **Misinterpretations of facts:** Ind AS 10 deals with treatment of the events after the reporting period. Whether the event is an adjusting event or a non-adjusting event depends on whether hat event provides evidence of a condition existing at the end of the reporting period. Sometimes, this requires judgement of the management and may result into misinterpretation of facts, if not dealt with properly.

(iv) **Omissions:** The mistakes that happened due to omission to record a material transaction, perhaps, due to oversight.

(v) **Frauds:** Major theft undetected in the past.

The abovementioned errors and any other error may happen while recognising the transaction, or while measuring the transaction, or while presenting it in financial statements or it might be possible that proper disclosure is not done.

Example

The following errors occurred in preparation of A Ltd.'s financial statements for the immediately preceding financial year –

(a) Depreciation on plant and machinery understated by an amount equal to 0.30% of sales;

(b) Warranty provisions understated by an amount equal to 0.15% of sales;

(c) Allowance for bad debts understated by an amount of 0.25% of sales.

Individually none of these errors may be material but could collectively influence the economic decision of the users of the financial statements. These are material prior period errors.

1.7.3 Treatment of Errors

Financial statements do not comply with Ind AS if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows.

1.7.3.1 Potential Errors of Current Period

Potential current period errors discovered in that period are corrected before the financial statements are approved for issue.

1.7.3.2 Prior period errors discovered subsequently

Material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period.

Situation 1: Error discovered relates to the comparative prior period presented:

Unless impracticable, an entity shall correct material prior period errors **retrospectively** in the first set of financial statements approved for issue after their discovery by **restating the comparative amounts for the prior period(s)** presented in which the error occurred;

Example

While preparing the financial statement for the financial year 20X2-20X3, the prior period presented would be financial year 20X1-20X2, if one year comparative period is presented. If the error occurred in the year 20X1-20X2 but discovered in year 20X2-20X3, then it should be corrected in the financial statements for the year 20X2-20X3 by restating the comparative amounts for the year 20X1-20X2. This will result in consequential restatement of opening balances for the year 20X2-20X3.

Situation 2: Error discovered relates to period before the earliest comparative prior period presented:

If the material error occurred before the earliest prior period presented, an entity shall, unless impracticable, correct the same retrospectively in the first set of financial statements approved for issue after their discovery by **restating the opening balances of assets, liabilities and equity for the earliest prior period presented**.

Example

An entity presents one year comparative period in its financial statements. While preparing the financial statements for the financial year 20X4-20X5, if an error has been discovered which occurred in the year 20X1-20X2, i.e., for the period which was earlier than earliest prior period presented (which is 20X3-20X4 in this example), then, the error should be corrected by restating the opening balances of relevant assets and/or liabilities and relevant component of equity for the year 20X3-20X4. This will result in consequential restatement of opening balances for the year 20X4-20X5.

Example

A material error in depreciation provision of the preceding year ended 31st March, 20X2 was discovered when preparing the financial statements for the year ended 31st March, 20X3. The amount recognised in statement of profit and loss for the year ended 31st March, 20X2 was

₹ 1,00,000 instead of ₹ 50,000. In this case, when presenting the financial statements for the year ended 31st March, 20X3, depreciation for the comparative year 20X1-20X2 will be restated at ₹ 50,000. The carrying amount i.e., net book value, of property, plant and equipment for the comparative year ending 31st March, 20X3 will be increased by ₹ 50,000 (due to restatement of accumulated depreciation). This will result in consequential restatement of opening balance of retained earnings and property, plant and equipment for the year 20X3-20X4.

Example

Continuing with the aforesaid example, assume that the error relates to year ended 31st March, 20X1 and 20X0-20X1 is not the earliest period for which comparative information is presented. In this case, the error will be corrected by restating the opening balances of retained earnings and carrying amount i.e., net book value, of property, plant and equipment, for the year 20X2-20X3, which will result in consequential restatement of opening balances for these items for the year 20X3-20X4.

Illustration 8

An entity has presented certain material liabilities as non-current in its financial statements for periods upto 31st March, 20X1. While preparing annual financial statements for the year ended 31st March, 20X2, management discovers that these liabilities should have been classified as current. The management intends to restate the comparative amounts for the prior period presented (i.e., as at 31st March, 20X1). Would this reclassification of liabilities from non-current to current in the comparative amounts be considered to be correction of an error under Ind AS 8? Would the entity need to present a third balance sheet?

Solution

As per paragraph 41 of Ind AS, errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not comply with Ind AS if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows. Potential current period errors discovered in that period are corrected before the financial statements are approved for issue. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period.

In accordance with the above, the reclassification of liabilities from non-current to current would be considered as correction of an error under Ind AS 8. Accordingly, in the financial statements for the year ended 31st March, 20X2, the comparative amounts as at 31st March, 20X1 would be restated to reflect the correct classification.

Ind AS 1 requires an entity to present a third balance sheet as at the beginning of the preceding period in addition to the minimum comparative financial statements, if, inter alia, it makes a retrospective restatement of items in its financial statements and the restatement has a material effect on the information in the balance sheet at the beginning of the preceding period.

Accordingly, the entity should present a third balance sheet as at the beginning of the preceding period, i.e., as at 1st April, 20X0 in addition to the comparatives for the financial year 20X0-X1.

*****

1.7.4 Limitations on retrospective restatement

We have already discussed in detail the treatment when there are the limitations on giving retrospective effect to changes in accounting policies. Similar provisions are included in Ind AS 8 to deal with limitations on retrospective restatement of prior period errors.

Step 1: A prior period error shall be corrected by retrospective restatement if it is practicable to determine both the period specific effects and cumulative effect of the error.

The correction of a prior period error is excluded from profit or loss for the period in which the error is discovered. Any information presented about prior periods, including any historical summaries of financial data, is restated as far back as is practicable.

Step 2: If it is not practicable to determine the period-specific effects of an error on comparative information for one or more prior periods presented, the entity shall first find out the earliest period for which retrospective restatement is practicable and then restate the opening balances of assets, liabilities and equity for that period. Ind AS 8 further states that such period can be the current period also.

For meaning of 'impracticable' for the purposes of Ind AS 8, see section 1.5.5.3.

Step 3: If it is not practicable to determine the cumulative effect, at the beginning of the current period, of an error on all prior periods, the entity shall restate the comparative information to correct the error prospectively from the earliest date practicable.

When it is impracticable to determine the amount of an error (e.g., a mistake in applying an accounting policy) for all prior periods, the entity restates the comparative information prospectively from the earliest date practicable. It therefore disregards the portion of the cumulative restatement of assets, liabilities and equity arising before that date.

Corrections of errors are distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need revision as additional information becomes known. For example, the gain or loss recognised on the outcome of a contingency is not the correction of an error.

1.8 DISCLOSURE OF PRIOR PERIOD ERRORS

An entity shall disclose the following:

(a) the nature of the prior period error;

(b) for each prior period presented, to the extent practicable, the amount of the correction:

  (i) for each financial statement line item affected; and

(ii) if Ind AS 33 applies to the entity, for basic and diluted earnings per share;

(c) the amount of the correction at the beginning of the earliest prior period presented; and

(d) if retrospective restatement is impracticable for a particular prior period, the circumstances that led to the existence of that condition and a description of how and from when the error has been corrected.

Financial statements of subsequent periods need not repeat these disclosures.

1.9 IMPRACTICABILITY IN RESPECT OF RETROSPECTIVE APPLICATION AND RETROSPECTIVE RESTATEMENT

In some circumstances, it is impracticable to adjust comparative information for one or more prior periods to achieve comparability with the current period.

For example, data may not have been collected in the prior period(s) in a way that allows either retrospective application of a new accounting policy (including, its prospective application to prior periods) or retrospective restatement to correct a prior period error, and it may be impracticable to recreate the information.

It is frequently necessary to make estimates in applying an accounting policy to elements of financial statements recognised or disclosed in respect of transactions, other events or conditions. Estimation is inherently subjective, and estimates may be developed after the reporting period. Developing estimates is potentially more difficult when retrospectively applying an accounting policy or making a retrospective restatement to correct a prior period error, because of the longer period of time that might have passed since the affected transaction, other event or condition occurred. However, the objective of estimates related to prior periods remains the same as for estimates made in the current period, namely, for the estimate to reflect the circumstances that existed when the transaction, other event or condition occurred.

Therefore, retrospectively applying a new accounting policy or correcting a prior period error requires distinguishing information that

(a) provides evidence of circumstances that existed on the date(s) as at which the transaction, other event or condition occurred, and

(b) would have been available when the financial statements for that prior period were approved for issue

from other information.

For some types of estimates (eg a fair value measurement that uses significant unobservable inputs), it is impracticable to distinguish these types of information. When retrospective application or retrospective restatement would require making a significant estimate for which it is impossible to distinguish these two types of information, it is impracticable to apply the new accounting policy or correct the prior period error retrospectively.

Hindsight should not be used when applying a new accounting policy to, or correcting amounts for, a prior period, either in making assumptions about what management's intentions would have been in a prior period or estimating the amounts recognised, measured or disclosed in a prior period. For example, when an entity corrects a prior period error in calculating its liability for employees' accumulated sick leave in accordance with Ind AS 19, 'Employee Benefits', it disregards information about an unusually severe influenza season during the next period that became available after the financial statements for the prior period were approved for issue. The fact that significant estimates are frequently required when amending comparative information presented for prior periods does not prevent reliable adjustment or correction of the comparative information.

1.10 SIGNIFICANT DIFFERENCES BETWEEN IND AS 8 AND AS 5

S. No.	Particulars	Ind AS 8	AS 5
	Title	**Accounting Policies, Changes in Accounting Estimates and Errors**	**Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies**
1.	*Objective*	Objective of Ind AS 8 is to prescribe the criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and corrections of errors. Ind AS 8 intends to enhance the relevance and reliability of an entity's financial statements and the comparability of those financial statements over time and with the financial statements of other entities.	Objective of AS 5 is to prescribe the classification and disclosure of certain items in the statement of profit and loss for uniform preparation and presentation of financial statements.
2.	*Extraordinary items*	Keeping in view that Ind AS 1, 'Presentation of Financial Statements', prohibits the presentation of any items of income or expense as	AS 5 deals with the concept of extraordinary items.

		extraordinary items, Ind AS 8 does not deal with the same.	
3.	*Definition of Accounting Policies*	Ind AS 8 broadens the definition to include bases, conventions, rules and practices (in addition to principles) applied by an entity in the preparation and presentation of financial statements.	AS 5 restricts the definition of accounting policies to specific accounting principles and the methods of applying those principles.
4.	*Change in accounting policies*	Ind AS 8 does not deal with change in accounting policy on the basis of the requirement by the statute.	AS 5 allows change in accounting policy if required by statute.
5.	*Selection and application of accounting policies*	Ind AS 8 specifically states that an entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless an Ind AS specifically requires or permits categorisation of items for which different policies may be appropriate.	Neither AS 5 nor any other AS specifically requires accounting policies to be consistent for similar transactions, other events and conditions.
6.	*Accounting for changes in accounting policies*	Ind AS 8 requires that changes in accounting policies should be accounted for with retrospective effect subject to limited exceptions viz., where it is impracticable to determine the period specific effects or the cumulative effect of applying a new accounting policy.	AS 5 does not specify how change in accounting policy should be accounted for.
7.	*Prior period items*	Ind AS 8 uses the term 'errors' and relates it to errors or omissions arising from a failure to use or misuse of reliable information (including mathematical mistakes, mistakes in application of accounting policies etc.) that was available when the	AS 5 defines prior period items as incomes or expenses which arise in the current period as a result of errors or omissions in the preparation of financial statements of one or more prior periods.

		financial statements of the prior periods were approved for issuance and could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. Ind AS 8 specifically states that errors include frauds.	This is not covered in AS 5.
8.	*Rectification of material prior period errors*	Ind AS 8 requires rectification of material prior period errors with retrospective effect subject to limited exceptions viz., where it is impracticable to determine the period specific effects or the cumulative effect of applying a new accounting policy.	AS 5 requires the rectification of prior period items with prospective effect.
9.	*Disclosure requirements*	Disclosure requirements of Ind AS 8 are more as compared to those of AS 5.	Disclosure requirements of AS 5 are less as compared to those of Ind AS 8.

TEST YOUR KNOWLEDGE

Questions

1. During 20X2, Delta Ltd., changed its accounting policy for depreciating property, plant and equipment, so as to apply much more fully a components approach, whilst at the same time adopting the revaluation model.

   In years before 20X2, Delta Ltd.'s asset records were not sufficiently detailed to apply a components approach fully. At the end of 20X1, management commissioned an engineering survey, which provided information on the components held and their fair values, useful lives, estimated residual values and depreciable amounts at the beginning of 20X2. However, the survey did not provide a sufficient basis for reliably estimating the cost of those components that had not previously been accounted for separately, and the existing records before the survey did not permit this information to be reconstructed.

   Delta Ltd.'s management considered how to account for each of the two aspects of the accounting change. They determined that it was not practicable to account for the change to a fuller components approach retrospectively, or to account for that change prospectively from any earlier date than the start of 20X2. Also, the change from a cost model to a revaluation model is required to be accounted for prospectively. Therefore, management concluded that it should apply Delta Ltd.'s new policy prospectively from the start of 20X2.

   Additional information:

   (i) Delta Ltd.'s tax rate is 30%

   (ii) Property, plant and equipment at the end of 20X1:

Cost	₹ 25,000
Depreciation	₹ 14,000
Net book value	₹ 11,000

   (iii) Prospective depreciation expense for 20X2 (old basis) ₹ 1,500

   (iv) Some results of the engineering survey:

Valuation	₹ 17,000
Estimated residual value	₹ 3,000
Average remaining asset life	7 years
Depreciation expense on existing property, plant and equipment for 20X2 (new basis)	₹ 2,000

   You are required to prepare relevant note for disclosure in accordance with Ind AS 8.

2. An entity charged off certain expenses as finance costs in its financial statements for the year ended 31st March, 20X1. While preparing annual financial statements for the year ended 31st March, 20X2, management discovered that these expenses should have been classified

as other expenses instead of finance costs. The error occurred because the management inadvertently misinterpreted certain facts. The entity intends to restate the comparative amounts for the prior period presented in which the error occurred (i.e., year ended 31st March, 20X1). Would this reclassification of expenses from finance costs to other expenses in the comparative amounts be considered to be correction of an error under Ind AS 8? Would the entity need to present a third balance sheet?

3. While preparing the annual financial statements for the year ended 31st March, 20X3, an entity discovers that a provision for constructive obligation for payment of bonus to selected employees in corporate office (material in amount) which was required to be recognised in the annual financial statements for the year ended 31st March, 20X1 was not recognised due to oversight of facts. The bonus was paid during the financial year ended 31st March, 20X2 and was recognised as an expense in the annual financial statements for the said year. Would this situation require retrospective restatement of comparatives considering that the error was material?

4. While preparing interim financial statements for the half-year ended 30th September, 20X1, an entity notes that there has been an under-accrual of certain expenses in the interim financial statements for the first quarter ended 30th June, 20X1. The amount of under accrual is assessed to be material in the context of interim financial statements. However, it is expected that the amount would be immaterial in the context of the annual financial statements. The management is of the view that there is no need to correct the error in the interim financial statements considering that the amount is expected to be immaterial from the point of view of the annual financial statements. Whether the management's view is acceptable?

5. ABC Ltd has an investment property with an original cost of ₹ 1,00,000 which it inadvertently omitted to depreciate in previous financial statements. The property was acquired on 1st April, 20X1. How should the error be corrected in the financial statements for the year ended 31st March, 20X4, assuming the impact of the same is considered material? The property has a useful life of 10 years and is depreciated using straight line method. Estimated residual value at the end of 10 year is Nil. For simplicity, ignore tax effects.

Answers

1. Extract from the notes

From the start of 20X2, Delta Ltd., changed its accounting policy for depreciating property, plant and equipment, so as to apply much more fully a components approach, whilst at the same time adopting the revaluation model. Management takes the view that this policy provides reliable and more relevant information because it deals more accurately with the components of property, plant and equipment and is based on up-to-date values. The policy has been applied prospectively from the start of 20X2 because it was not practicable to estimate the effects of applying the policy either retrospectively, or prospectively from any earlier date. Accordingly, the adoption of the new policy has no effect on prior years. The effect on the current year is to increase the carrying amount of property, plant and equipment at the start of the year by ₹ 6,000; increase the opening deferred tax provision by ₹ 1,800; create a revaluation surplus at the start of the year of ₹ 4,200; increase depreciation expense by ₹ 500; and reduce tax expense by ₹ 150.

2. As per paragraph 41 of Ind AS 8, errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not comply with Ind AS if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows. Potential current period errors discovered in that period are corrected before the financial statements are approved for issue. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period.

   In accordance with the above, the reclassification of expenses from finance costs to other expenses would be considered as correction of an error under Ind AS 8. Accordingly, in the financial statements for the year ended 31st March, 20X2, the comparative amounts for the year ended 31st March, 20X1 would be restated to reflect the correct classification.

   Ind AS 1 requires an entity to present a third balance sheet as at the beginning of the preceding period in addition to the minimum comparative financial statements if, inter alia, it makes a retrospective restatement of items in its financial statements and the restatement has a material effect on the information in the balance sheet at the beginning of the preceding period.

   In the given case, the retrospective restatement of relevant items in statement of profit and loss has no effect on the information in the balance sheet at the beginning of the preceding period (1st April, 20X0). Therefore, the entity is not required to present a third balance sheet.

3. As per paragraph 41 of Ind AS 8, errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not comply with Ind AS if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows. Potential current period errors discovered in that period are corrected before the financial statements are approved for issue. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period.

   As per paragraph 40A of Ind AS 1, an entity shall present a third balance sheet as at the beginning of the preceding period in addition to the minimum comparative financial statements if, inter alia, it makes a retrospective restatement of items in its financial statements and the retrospective restatement has a material effect on the information in the balance sheet at the beginning of the preceding period.

   In the given case, expenses for the year ended 31st March, 20X1 and liabilities as at 31st March, 20X1 were understated because of non-recognition of bonus expense and related provision. Expenses for the year ended 31st March, 20X2, on the other hand, were overstated to the same extent because of recognition of the aforesaid bonus as expense for the year. To correct the above errors in the annual financial statements for the year ended 31st March, 20X3, the entity should:

(a) restate the comparative amounts (i.e., those for the year ended 31st March, 20X2) in the statement of profit and loss; and

(b) present a third balance sheet as at the beginning of the preceding period (i.e., as at 1st April, 20X1) wherein it should recognise the provision for bonus and restate the retained earnings.

4. Paragraph 41 of Ind AS 8, inter alia, states that financial statements do not comply with Ind AS if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows.

As regards the assessment of materiality of an item in preparing interim financial statements, paragraph 25 of Ind AS 34, Interim Financial Statements, states as follows:

"While judgement is always required in assessing materiality, this Standard bases the recognition and disclosure decision on data for the interim period by itself for reasons of understandability of the interim figures. Thus, for example, unusual items, changes in accounting policies or estimates, and errors are recognised and disclosed on the basis of materiality in relation to interim period data to avoid misleading inferences that might result from nondisclosure. The overriding goal is to ensure that an interim financial report includes all information that is relevant to understanding an entity's financial position and performance during the interim period."

As per the above, while materiality judgements always involve a degree of subjectivity, the overriding goal is to ensure that an interim financial report includes all the information that is relevant to an understanding of the financial position and performance of the entity during the interim period. It is therefore not appropriate to base quantitative assessments of materiality on projected annual figures when evaluating errors in interim financial statements.

Accordingly, the management is required to correct the error in the interim financial statements since it is assessed to be material in relation to interim period data.

5. The error shall be corrected by retrospectively restating the comparatives. A third balance sheet as at the beginning of the earliest period shall also be presented. Relevant extracts of balance sheet, statement of profit and loss and statement of changes in equity are reproduced below:

Balance sheet		**Restated**	**Restated**
	31st March, 20X4 ₹	31st March, 20X3 ₹	1st April, 20X2 ₹
Non-current assets			
Property, plant and equipment	60,500	64,500	70,000

Investment property (refer note 1 below)	70,000	80,000	90,000
Total non-current assets	130,500	144,500	160,000
Current Assets			
Cash	50,000	40,000	60,000
Trade receivables	80,000	100,000	90,000
Total current assets	130,000	140,000	150,000
Total assets	260,500	284,500	310,000
Equity and liabilities			
Equity			
Equity share capital	50,000	50,000	50,000
Other equity			
Reserves and surplus	80,500	60,500	40,000
Total equity	130,500	110,500	90,000
Liabilities			
Current liabilities			
Financial liabilities			
Trade payables	100,000	135,000	122,000
Other financial liabilities	30,000	39,000	98,000
Total liabilities	1,30,000	1,74,000	2,20,000
Total Equity and Liabilities	260,500	284,500	310,000

Statement of profit and loss		**Restated**
	31st March, 20X4	31st March, 20X3
	₹	₹
Revenue from operations	48,000	50,000
Other income	2,000	3,000
Total Income	50,000	53,000
Expenses		
Purchases of stock-in-trade	15,500	16,700
(Increase)/Decrease in inventories of Stock-in-Trade	500	300
Depreciation expense (refer note 1 below)	14,000	15,500
Total expenses	30,000	32,500
Profit for the year	20,000	20,500

Statement of changes in equity		Restated
	Equity share capital	Retained earnings
	₹	₹
Balance as at 1st April, 20X2 as previously reported	50,000	50,000
Impact of the depreciation on investment property for FY 20X1-X2 (Refer note 1)	-	(10,000)
Restated balance as at 1st April, 20X2	50,000	40,000
Profit for the FY 20X2-X3 (restated)	-	20,500
Balance as at 31st March, 20X3	50,000	60,500
Profit for the FY 20X3-X4	-	20,000
Balance as at 31st March, 20X4	50,000	80,500

Note 1:

During the year ended 31st March 20X4, the management undertook a detailed review of its accounting policies and observed that investment property had not been depreciated in previous financial statements due to oversight. As a consequence, the investment property had been incorrectly measured at the original historical cost instead of the depreciated carrying value.

Due to this error, the investment property and retained earnings as at 1st April, 20X2 were overstated by ₹ 10,000 each. The error also affected the profit for the year ended 31st March, 20X3 which was overstated by ₹ 10,000. The investment property and retained earnings as at 31st March, 20X3 were overstated by ₹ 20,000 each

The error has been corrected by restating each of the affected financial statement line items for the prior periods as follows:

						(All figures in ₹)
Balance sheet	31st March, 20X3 (as previously reported)	Increase/ (decrease) due to correction of error	31st March, 20X3 (restated)	1st April, 20X2 (as previously reported)	Increase/ (decrease) due to correction of error	1st April, 20X2 (restated)
Investment property	100,000	(20,000)	80,000	100,000	(10,000)	90,000
Total Non-current assets	164,500	(20,000)	144,500	170,000	(10,000)	160,000
Total assets	304,500	(20,000)	284,500	320,000	(10,000)	310,000
Retained earnings	80,500	(20,000)	60,500	50,000	(10,000)	40,000
Total equity	130,500	(20,000)	110,500	100,000	(10,000)	90,000

Statement of profit and loss	**31st March, 20X3 (as previously reported)**	**Increase/(decrease) due to correction of error**	**31st March, 20X3 (restated)**
Depreciation	5,500	10,000	15,500
Total expenses	22,500	10,000	32,500
Profit for the year	30,500	(10,000)	20,500

Basic and diluted earnings per share for the prior year have also been restated. The amount of the correction for both basic and diluted earnings per share was a decrease of ₹ 0.20 per share.

The correction of the error had no impact on previously reported cash flows from operating, investing and financing activities.

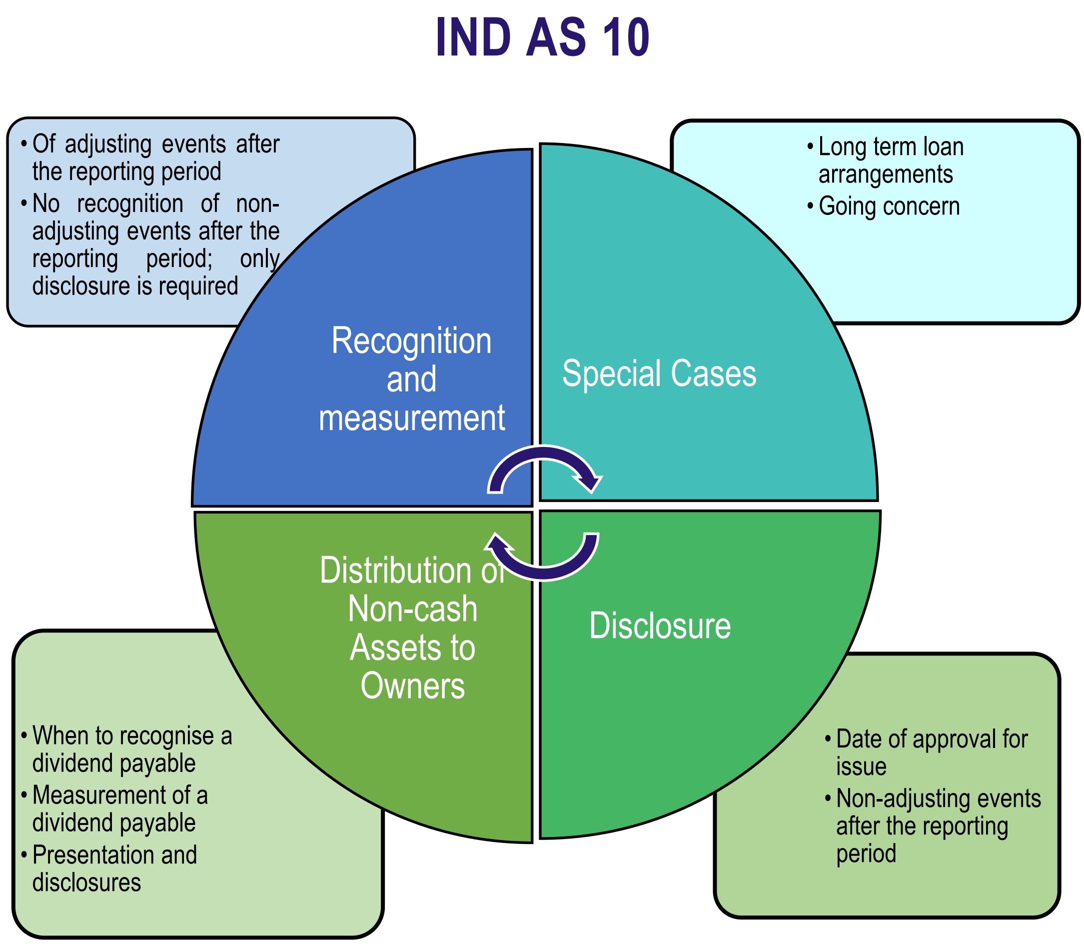
UNIT 2:
IND AS 10: EVENTS AFTER THE REPORTING PERIOD

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Define the relevant terms like 'events after the reporting period',' date of approval', 'adjusting events' and 'non-adjusting events'.
- Differentiate between adjusting events and non-adjusting events in terms of their treatment and disclosure.
- Understand the treatment for special cases.

UNIT OVERVIEW



2.1 INTRODUCTION

It is impossible for any company to present the information on the same day, as the day of reporting. There would always be a gap between the end of the period for which financial statements are presented and the date on which the same will actually be made available to the public.

During this gap, there is a possibility of occurring of few events which will have far reaching effects on the business / existence of the company. Now the question arises: what view the company should take about such events? Should it leave it without any cognizance as they are taking place after the reporting period, or should it take cognizance of such events as at the time of making it public? If the company is aware of the facts and is still not disclosing the same, it may mislead the users.

Ind AS 10 deals with such events and provides guidance about its treatment in the financial statements.

2.2 OBJECTIVE

The objectives of the standard are divided mainly in three points.

1. **Guidelines for taking a decision** regarding adjusting or not adjusting the financial statements for the events after the reporting period.
2. **Guidelines regarding the disclosures** that an entity should give about the date when the financial statements were approved for issue and about events after the reporting period.
3. **Guidelines when the going concern assumption is no longer appropriate:** The standard requires that an entity should not prepare its financial statements on a going concern basis if events after the reporting period indicate that the going concern assumption is no longer appropriate.

2.3 SCOPE

The Standard is mainly applicable in respect of the following two matters:

1. **Accounting** for events after reporting period
2. **Disclosure** of events after the reporting period.

2.4 DEFINITIONS AND EXPLANATIONS

We have seen above that the main focus of the standard is **events after the reporting period.** Therefore, it is necessary to understand the meaning of it.

2.4.1 Events after the Reporting Period

Events after the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are approved.

Example

The financial year of an entity ends on 31st March, 20X2. If the board of directors approves the financial statements on 15th May, 20X2, 'after the reporting period' will be the period between 31st March, 20X2 and 15th May, 20X2 and the events occurring during this period should be considered as 'events after the reporting period'.

2.4.2 Approval of Financial statements

The definition says that the last date of the concerned period is the date of approval of financial statements. Now the question arises: what is meant by approval of financial statements? When can one say that the financial statements are approved? Which body needs to be considered as approving authority? If there is a hierarchy of approvals, at what level, one can assume that the financial statements are approved?

As per the standard,

(i) **In case of a company:** The financial statements will be treated as approved when board of directors approves the same.

(ii) **In the case of any other entity:** The financial statements will be treated as approved when the corresponding approving authority approves the same. The standard does not mention specifically what will constitute the approving authority in case of any other entity. But from the word **"Corresponding"** one can construe that it is the body which is authorised to manage the entity on behalf of all members.

(iii) **If shareholders' approval is must**, then should the approval date be considered as the date on which the shareholders approve it?

Even though shareholders' approval is needed, yet, for the purpose of deciding the events after the reporting period, the date of approval will be considered as the date of approval by the board of directors only.

Example

The Board of Directors of ABC Ltd., in its meeting on 5th May, 20X1, reviews and approves the financial statements for the year ended 31st March, 20X1 and issues them to the shareholders. The financial statements are adopted by the shareholders in the annual general meeting on 23rd June, 20X1. The date of approval of financial statements for the purpose of this standard is 5th May, 20X1.

(iv) What date should be considered, if in some cases, the management of an entity is required to issue its financial statements to **a supervisory board** (made up solely of non-executives) for approval?

In such cases, the financial statements are approved for issue when the management approves them for issue to the supervisory board.

Example

On 18th May, 20X2, the management of an entity approves financial statements for issue to its supervisory board. The supervisory board is made up solely of non-executives and may include representatives of employees and other outside interests. The supervisory board approves the financial statements on 26th May, 20X2. The financial statements are made available to shareholders and others on 1st June, 20X2. The shareholders approve the financial statements at their annual meeting on 15th July, 20X2 and the financial statements are then filed with a regulatory body on 17th July, 20X2. The financial statements are approved for issue on 18th May, 20X2 (date of management approval for issue to the supervisory board).

2.4.3 When date of approval is after the public announcement of some other financial information

'Events after the reporting period' include all events up to the date when the financial statements are approved for issue, even if those events occur after the public announcement of profit or of other selected financial information.

Example

The financial year ends on 31st March, 20X7. A company can conduct the AGM any time before 30th September, 20X7. However, the company needs to publish the results for quarter ended 30th June, 20X7 as interim results. The board of the directors (BOD) approves the financial statements on 30th August, 20X7. As BOD is approving the accounts on 30th August, 20X7, 'after the reporting period' will be the period between 31st March, 20X7 and 30th August, 20X7. However, in between, the partial financial information has already been published.

Now the question arises that if any information is revealed after the release of interim results for the quarter ended 30th June, 20X7, but before 30th August, 20X7, should it be considered for the purposes of Ind AS 10 or not since partial information has already been published without considering the event that was revealed after publishing some financial information? Will taking the cognizance of the additional information confuse the stakeholders? Will it be misleading?

In such a situation, Ind AS 10 requires that even if partial information has already been published, events after the reporting period should be considered.

Illustration 1

What is the date of approval for issue of the financial statements prepared for the reporting period from April 1, 20X1 to March 31, 20X2, in a situation where following dates are available? Completion of preparation of financial statements May 28, 20X2 Board reviews and approves it for issue June 19, 20X2

Available to shareholders	*July 01, 20X2*
Annual General Meeting	*September 15, 20X2*
Filed with regulatory authority	*October 16, 20X2*

Will your answer differ if the entity is a partnership firm?

Solution

As per Ind AS 10 the date of approval for issue of financial statements is 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. Accordingly, in the instant case, the date of approval is the date on which the financial statements are approved by the Board of

Directors of the company, i.e., June 19, 20X2.

In the case of an entity is a partnership firm, the date of approval will be the date when the relevant approving authority of such entity approves the financial statements for issue ie. the date when the partner(s) of the firm approve(s) the financial statements.

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Illustration 2

ABC Ltd. prepared interim financial report for the quarter ending June 30, 20X1. The interim financial report was approved for issue by the Board of Directors on July 15, 20X1. Whether events occurring between end of the interim financial report and date of approval by Board of Directors, i.e., events between July 1, 20X1 and July 15, 20X1 that provide evidence of conditions that existed at the end of the interim reporting period shall be adjusted in the interim financial report ending June 30, 20X1?

Solution

Paragraph 3 of Ind AS 10, *inter alia*, defines 'Events after the reporting period' as those events, favourable and unfavourable, that occur between the end of the reporting period and the date when 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 for issue.

What is reporting period has not been dealt with in Ind AS 10. Absence of any specific guidance regarding reporting period implies that any term for which reporting is done by preparing financial statements is the reporting period for the purpose of Ind AS 10. Accordingly, financial reporting done for interim period by preparing either complete set of financial statements or by preparing condensed financial statements will be treated as reporting period for the purpose of Ind AS 10.

Paragraph 2 of Ind AS 34, *inter alia*, provides that each financial report, annual or interim, is evaluated on its own for conformity with Ind AS. Further, paragraph 19 of Ind AS 34, provides that an interim financial report shall not be described as complying with Ind AS unless it complies with all of the requirements of Ind AS.

In accordance with the above, an entity describing that its interim financial report is in compliance with Ind AS, has to comply with all the Ind AS including Ind AS 10.

In order to comply with the requirements of Ind AS 10, each interim financial report should be adjusted for the adjusting events occurring between end of the interim financial report and the date of approval by Board of Directors. Therefore, in the instant case, events occurring between July 1, 20X1 and July 15, 20X1 that provide evidence of conditions that existed at the end of the interim reporting period should be adjusted in the interim financial report ending June 30, 20X1.

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Illustration 3

The Board of Directors of ABC Ltd. approved the financial statements for the reporting period 20X1-X2 for issue on June 15, 20X2. The management of ABC Ltd. discovered a major fraud and decided to reopen the books of account. The financial statements were subsequently approved by the Board of Directors on June 30, 20X2. What is the date of approval for issue as per Ind AS 10 in the given case?

Solution

Date of approval is 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 for issue. In the given case, there are two dates of approval by Board of Directors. The financial statements were reopened for further adjustments subsequent to initial approval. The date of approval should be taken as the date on which financial statements are finally approved by the Board of Directors. T herefore, in the given case, the date of approval for issue as per Ind AS 10 should be considered as June 30, 20X2.

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2.4.4 Should the company report only unfavourable events?

The standard clearly states that events can be favourable as well as unfavourable.

2.5 TYPES OF EVENTS

The 'events after the reporting period' are classified into two categories

(i) **Adjusting Events:** those that provide **evidence** of conditions that existed **at the end of the reporting period** (adjusting events after the reporting period); and

(ii) **Non Adjusting Events:** those that are **indicative** of conditions that arose **after the reporting period** (non-adjusting events after the reporting period).

2.6 RECOGNITION AND MEASUREMENT OF ADJUSTING EVENTS

An entity shall adjust the amounts recognised in its financial statements to reflect adjusting events after the reporting period.

Examples of adjusting events after the reporting period

The following are examples of adjusting events after the reporting period that require an entity to adjust the amounts recognised in its financial statements, or to recognise items that were not previously recognised:

(a) The settlement after the reporting period of a court case that confirms that the entity had a present obligation at the end of the reporting period. The entity adjusts any previously recognised provision related to this court case in accordance with Ind AS 37, 'Provisions, Contingent Liabilities and Contingent Assets' or recognises a new provision.

The entity does not merely disclose a contingent liability because the settlement provides additional evidence that would be considered in accordance with paragraph 16 of Ind AS 37.

Illustration 4

A case is going on between ABC Ltd., and GST department on claiming some exemption for the year 20X1-20X2. The court has issued the order on 15th April, 20X2 and rejected the claim of the company. Accordingly, the company is liable to pay the additional tax. The financial statements of the company for the year 20X1-20X2 have been approved on 15th May, 20X2. Should the company account for such tax in the year 20X1-20X2 or should it account for the same in the year 20X2-20X3?

Solution

An event after the reporting period is an adjusting event, if it provides evidence of a condition existing at the end of the reporting period. Here, this condition is satisfied. Court order received after the reporting period provides the evidence of the liability existing at the end of the reporting period. Therefore, the event will be considered as an adjusting event and, accordingly, the amounts will be adjusted in financial statements for 20X1-20X2.

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(b) The receipt of information after the reporting period indicating that an asset was impaired at the end of the reporting period, or that the amount of a previously recognised impairment loss for that asset needs to be adjusted. For example:

(i) The bankruptcy of a customer that occurs after the reporting period usually confirms that the customer was credit-impaired at the end of the reporting period;

Example

Loss allowance for expected credit loss in respect of the amount due from a customer was recognised at the end of the reporting period in accordance with Ind AS 109, 'Financial Instruments'. Subsequent liquidation order on the customer issued before the date of approval of financial statements for the reporting period indicates that nothing could be received from the customer. This confirms that the expected credit loss at the end of the reporting period on this particular trade receivable is equal to its gross carrying amount and, consequently, the entity needs to adjust the loss allowance for the expected credit loss at the end of the reporting period so that net carrying amount of this particular trade receivable at the end of the reporting period is zero.

Illustration 5

While preparing its financial statements for the year ended 31st March, 20X1, XYZ Ltd. made a general provision for bad debts @ 5% of its debtors. In the last week of February, 20X1 a debtor for Rs. 2 lakhs had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. Considering the event of earthquake, XYZ Ltd. made a provision @ 50% of the amount receivable from that debtor apart from the general provision of 5% on remaining debtors. In April, 20X1 the debtor became bankrupt. Can XYZ Ltd. provide for the full loss arising out of insolvency of the debtor in the financial statements for the year ended 31st March, 20X1?

Would the answer be different if earthquake had taken place after 31st March, 20X1, and therefore, XYZ Ltd. did not make any specific provision in context that debtor and made only general provision for bad debts @ 5% on total debtors?

Solution

As per the definition of 'Events after the Reporting Period' and paragraph 8 of Ind AS 10, Events after the Reporting Period, financial statements should be adjusted for events occurring after the reporting period that provide evidence of conditions that existed at the end of the reporting period. In the instant case, the earthquake took place before the end of the reporting period, i.e., in February 20X1. Therefore, the condition exists at the end of the reporting date though the debtor is declared insolvent after the reporting period. Accordingly, full provision for bad debt amounting to ₹ 2 lakhs should be made to cover the loss arising due to the bankruptcy of the debtor in the financial statements for the year ended March 31, 20X1. Since provision for bad debts on account of amount due from that particular debtor was made @ 50%, XYZ Ltd should provide for the remaining amount as a consequence of declaration of this debtor as bankrupt.

In case, the earthquake had taken place after the end of the reporting period, i.e., after 31st March, 20X1, and XYZ Ltd. had not made any specific provision for the debtor who was declared bankrupt later on, since the earthquake occurred after the end of the reporting period no condition existed at the end of the reporting period. The company had made only general provision for bad debts in the ordinary business course and not to recognise the catastrophic situation of an earthquake. Accordingly, bankruptcy of the debtor in this case is a non-adjusting event.

As per para 21 of Ind AS 10, if non-adjusting events after the reporting period are material, non-disclosure could influence the economic decisions that users make on the basis of the financial statements. Accordingly, an entity shall disclose the following for each material category of non-adjusting event after the reporting period:

(a) the nature of the event; and

(b) an estimate of its financial effect, or a statement that such an estimate cannot be made."

If the amount of bad debt is considered to be material, the nature of this non-adjusting event, i.e., event of bankruptcy of the debtor should be disclosed along with the estimated financial effect of the same in the financial statements.

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(ii) The sale of inventories after the reporting period may give evidence about their net realisable value at the end of the reporting period.

While making the valuation of closing inventories, Ind AS 2, Inventories, prescribes the general principle that the inventories need to be valued at cost or net realisable value, whichever is less. In such cases, net realisable value is based on sales after the reporting period. However, normally that would be the most realistic value to be applied to the closing inventories, if it is less than cost. Therefore, in such cases, the value which is available after the reporting period will be used for valuation of closing inventories of the reporting period, if the same is less than cost.

Example

Entity A values its inventories at cost or NRV, whichever is less. Entity A has 10 pieces of item A in its stock at the year end. Each item costs ₹ 500. All these items are sold subsequently but before the date of approval of financial statements for the reporting period at ₹ 450 per piece. The sale of inventories after the reporting period normally provides evidence about their net realisable value at the end of the reporting period.

Illustration 6

A company has inventory of 100 finished cars on 31st March, 20X2, which are having a cost of ₹ 4,00,000 each. On 30th April, 20X2, as per the new government rules, higher road tax and penalties are to be paid by the buyers for such cars (which were already expected to come) and hence the selling price of a car has come down and the demand for such cars has dropped drastically. The selling price has come down to ₹ 3,00,000 each. The financial statements of the company for the year 20X1-20X2 are not yet approved. Should the company value its stock at ₹ 4,00,000 each or should it value at ₹ 3,00,000 each? Ignore estimated costs necessary to make the sale.

Solution

Events after the reporting period provide the evidence about the net realisable value of the cars at the end of the reporting period and, therefore, the amount of ₹ 3,00,000 should be considered for the valuation of stock.

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(c) The determination after the reporting period of the cost of assets purchased, or the proceeds from assets sold, before the end of the reporting period.

Same principle can be applied for sale of assets as well.

Example

The sale of an asset took place in March, 20X2. However, the actual consideration was determined and collected after 31st March, 20X2, i.e., on 10th May, 20X2 (date of approval of financial statements was 15th May, 20X2). In such a situation, sale value recognised in the books as on 31st March, 20X2 should be adjusted.

Illustration 7

ABC Ltd., has purchased a new machinery during the year 20X1-20X2. The asset was finally installed and made ready for use on 15th March, 20X2. However, the company involved in installation and training, which was also the supplier, has not yet submitted the final bills for the same.

The supplier company sent the bills on 10th April, 20X2, when the financial statements were not yet approved. Should the company adjust the amount of capitalisation in the year 20X1-20X2 or in the year 20X2-20X3?

Solution

As per the provisions of the contract, the cost of installation and training of new machine is an integral part of the cost of asset purchased. Therefore, even if the details are available after reporting period, they provide proof about the circumstances that existed at the end of reporting period. Therefore, the cost of installation and training will be considered for capitalisation in the year 20X1-20X2.

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(d) The determination after the reporting period of the amount of profit-sharing or bonus payments, if the entity had a present legal or constructive obligation at the end of the reporting period to make such payments as a result of events before that date (see Ind AS 19, Employee Benefits).

The careful reading of the above provision brings forth following two points:

(i) There is a legal or constructive obligation at the end of reporting period

(ii) The obligation is based on profit sharing or bonus payments.

Here one would understand that before the year end, one cannot determine the amount of profit. Unless one determines the final amount of profit, one cannot finalise the amount of profit sharing as the latter is related to the former. Therefore, such events must be considered for the adjustments in financial statements, provided, the contract already exists on the last day of reporting period.

(e) The discovery of fraud or errors that show that the financial statements are incorrect.

Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors, inter alia, deals with errors that occurred in the previous period(s), which includes, for the purposes of that standard, frauds. However, Ind AS 10 focuses on the errors including frauds which are revealed after the reporting period. In any case, the entity is not supposed to present any misstatement to the stakeholders, especially when it has knowledge about the errors and frauds. Therefore, if any error or any fraud is detected after the reporting period, which is related to the reporting period, then the entity must adjust the financial statements appropriately by rectifying the same.

2.7 ACCOUNTING TREATMENT AND DISCLOSURE OF NON-ADJUSTING EVENTS AFTER THE REPORTING PERIOD

An entity shall not adjust the amounts recognised in its financial statements to reflect non-adjusting events after the reporting period.

An example of a non-adjusting event after the reporting period is a decline in fair value of investments between the end of the reporting period and the date when the financial statements are approved for issue. The decline in fair value does not normally relate to the condition of the investments at the end of the reporting period, but reflects circumstances that have arisen subsequently. Therefore, an entity does not adjust the amounts recognised in its financial statements for the investments. Similarly, the entity does not update the amounts disclosed for the investments as at the end of the reporting period, although it may need to give additional disclosure.

2.8 SPECIAL CASES

2.8.1 Long-term Loan Arrangements

Notwithstanding anything contained in the definition of non-adjusting events, where there is a breach of a material provision 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 on the reporting date, the agreement by lender before the approval of the financial statements for issue, to not demand payment as a consequence of the breach, shall be considered as an adjusting event.

Example

ABC Ltd., in order to raise funds, has privately placed debentures of ₹ 1 crore, on 1st January, 20X1, issued to PQR Ltd. As per the original terms of agreement, the debentures are to be redeemed on 31st March, 20X9. One of the conditions of the private placement of the debentures was that debt-equity ratio at the end of any reporting year should not exceed 2:1. If this condition is not fulfilled, then, PQR Ltd., has a right to demand immediate redemption of the debentures. On 31st March, 20X6, debt-equity ratio of ABC Ltd., exceeds 2:1. Therefore, PQR Ltd., decides to return the debentures.

Thus, on 31st March, 20X6, the liability of the ABC Ltd., towards PQR Ltd., (which was originally a long-term liability) becomes a current liability, since, it is now a liability on demand. However, ABC Ltd., enters into an agreement with PQR Ltd., on 15th April, 20X6 that PQR Ltd., will not demand the payment immediately. The financial statements are approved by the BOD on 30th April, 20X6.

Now, in such a case, the liability is turning into demand liability on 31st March, 20X6. The agreement that PQR Ltd., will not demand the money immediately is a subsequent event. Even though it is a subsequent event not affecting the condition existing at the balance sheet date, yet because of the specific provisions of Ind AS 10, it has to be given effect in the financial statements for the year 20X5-20X6. Accordingly, though as per original terms the liability would have been otherwise reclassified as a current liability as on 31st March, 20X6, by giving effect to the event after the reporting period due to the specific provisions of Ind AS 10, it would continue to be classified as a non-current liability as on 31st March, 20X6. In other words, the re-classification of debentures as current liability as at 31st March, 20X6 will be adjusted and once again classified as a non-current liability as at that date.

2.8.2 Going Concern

- An entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so.
- Deterioration in operating results and financial position after the reporting period may indicate a need to consider whether the going concern assumption is still appropriate. If the going concern assumption is no longer appropriate, the effect is so pervasive that this standard requires a fundamental change in the basis of accounting, rather than an adjustment to the amounts recognised within the original basis of accounting.
- Ind AS 1 specifies required disclosures if:

  (a) the financial statements are not prepared on a going concern basis; or

  (b) management is aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern. The events or conditions requiring disclosure may arise after the reporting period.

Going concern approach has a lot of importance in the financial statements. Going concern approach can be applied if and only if the entity has intentions to continue its operations. The carrying amount of assets and carrying amount of liabilities will be much different if the entity has plans to go in for liquidation.

Example

A going concern company assumes that the raw material inventory and work in progress will be completed in due course and the inventories of finished goods would be ready for sale. But, if the company has no intention to continue with the business, it may take a decision to sell the raw material and WIP at best available market price, may be at scrap value also.

If a company decides to go into liquidation, then the long-term liabilities of the company will turn into short-term liabilities as the company will have to pay all its debts before it closes down its operations. Thus, the overall approach of accounting will change when there is no going concern approach.

Therefore, Ind AS 10, specifically requires that if after the reporting period but before approval of the financial statements, there are any signs of not continuing the operations, or the decision is taken during that period not to continue with the operations, inspite of the fact that the decision was taken after the reporting period, still the entity should prepare the financial statements with a different approach and, accordingly, inform the stakeholders clearly that the is planning to cease operations.

Illustration 8

Company XYZ Ltd. was formed to secure the tenders floated by a telecom company for publication of telephone directories. It bagged the tender for publishing directories for Pune circle for 5 years. It has made a profit in 20X1- 20X2, 20X2-20X3, 20X3-20X4 and 20X4-20X5. It bid in tenders for publication of directories for other circles – Nagpur, Nashik, Mumbai, Hyderabad but as per the results declared on 23rd April, 20X5, the company failed to bag any of these. Its only activity till date is publication of Pune directory. The contract for publication of directories for Pune will expire on 31st December 20X5. The financial statements for the F.Y. 20X4-X5 have been approved by the Board of Directors on July 10, 20X5. Whether it is appropriate to prepare financial statements on going concern basis?

Solution

With regard to going concern basis to be followed for preparation of financial statements, paras 14 & 15 of Ind AS 10 states that-

An entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so.

Deterioration in operating results and financial position after the reporting period may indicate a need to consider whether the going concern assumption is still appropriate. If the going concern assumption is no longer appropriate, the effect is so pervasive that this Standard requires a fundamental change in the basis of accounting, rather than an adjustment to the amounts recognised within the original basis of accounting.

In accordance with the above, an entity needs to change the basis of accounting if the effect of deterioration in operating results and financial position is so pervasive that management determines after the reporting period either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so.

In the instant case, since contract is expiring on 31st December 20X5 and it is confirmed on 23rd April, 20X5, i.e., after the end of the reporting period and before the approval of the financial statements, that no further contact is secured, implies that the entity's operations are expected to come to an end. Accordingly, if entity's operations are expected to come to an end, the entity needs to make a judgement as to whether it has any realistic possibility to continue or not. In case, the entity determines that it has no realistic alternative of continuing the business, preparation of financial statements for 20X4-X5 and thereafter on going concern basis may not be appropriate.

Illustration 9

In the plant of PQR Ltd., there was a fire on 10.05.20X1 in which the entire plant was damaged and the loss of Rs. 40,00,000 is estimated. The claim with the insurance company has been filed and a recovery of Rs. 27,00,000 is expected.

The financial statements for the year ending 31.03.20X1 were approved by the Board of Directors on 12th June 20X1. Show how should it be disclosed?

Solution

In the instant case, since fire took place after the end of the reporting period, it is a non-adjusting event. However, in accordance with paragraph 21 of Ind AS 10, disclosures regarding non-adjusting event should be made in the financial statements, i.e., the nature of the event and the expected financial effect of the same.

With regard to going concern basis followed for preparation of financial statements, the company needs to determine whether it is appropriate to prepare the financial statements on going concern basis, since there is only one plant which has been damaged due to fire. If the effect of deterioration in operating

results and financial position is so pervasive that management determines after the reporting period either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so, preparation of financial statements for the F.Y.20X0-X1 on going concern assumption may not be appropriate. In that case, the financial statements may have to be prepared on a basis other than going concern.

However, if the going concern assumption is considered to be appropriate even after the fire, no adjustment is required in the financial statements for the year ending 31.03.20X1.

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2.9 DIVIDENDS

- If an entity declares dividends to holders of equity instruments (as defined in Ind AS 32, Financial Instruments: Presentation) after the reporting period, the entity shall not recognise those dividends as a liability at the end of the reporting period.
- If dividends are declared after the reporting period but before the financial statements are approved for issue, the dividends are not recognised as a liability at the end of the reporting period because no obligation exists at that time. Such dividends are disclosed in the notes in accordance with Ind AS 1, Presentation of Financial Statements.
- The crux of difference between adjusting event and non-adjusting event depends on the fact whether the event provides evidence for existence of a condition at the end of reporting period or not.

Illustration 10

ABC Ltd., declares the dividend on 15th July, 20X2 as the results of year 20X1-20X2 as well as Q1 ending 30th June, 20X2 are better than expected. The financial statements of the company are approved on 20th July, 20X2 for the financial year ending 31st March, 20X2. Will the dividend be accounted for in the financial year 20X2-20X3 or will it be accounted for in the year 20X1-20X2?

Solution

The dividend is declared in the year 20X2-20X3. Therefore, the obligation towards dividend did not exist at the end date of reporting period i.e., on 31st March, 20X2. Therefore, it will be accounted for in the year 20X2-20X3 and not in 20X1-20X2, even if financial statements for 20X1-20X2 were approved after the declaration of dividend. It will, however, be disclosed in the notes in the financial statements for the year 20X1-20X2 in accordance with Ind AS 1.

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Illustration 11

What would be the treatment for dividends declared to redeemable preference shareholders after the reporting period but before the financial statements are approved for issue for the year 20X1-X2. Whether Ind AS 10 prescribes any accounting treatment for such dividends?

Solution

Paragraph 12 of Ind AS 10 prescribes accounting treatment for dividends declared to holders of equity instruments. If an entity declares dividends to holders of equity instruments (as defined in Ind AS 32, Financial Instruments: Presentations) after the reporting period, the entity shall not recognise those dividends as a liability at the end of the reporting period.

However, Ind AS 10 does not prescribe accounting treatment for dividends declared to redeemable preference shareholders. As per the principles of Ind AS 32, Financial Instruments: Presentation, a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability. Thus, dividend payments to such preference shares are recognised as expense in the same way as interest on a bond. Since interest will be charged on time basis, the requirements of Ind AS 10 regarding date of declaration of dividend not relevant for its recognition.

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2.10 DISCLOSURE

2.10.1 Date of approval for issue

- An entity shall disclose the date when the financial statements were approved for issue and who gave that approval. If the entity's owners or others have the power to amend the financial statements after issue, the entity shall disclose that fact.
- It is important for users to know when the financial statements were approved for issue, because the financial statements do not reflect events after this date.

Ind AS 10, underlines the importance of date of approval, by requiring a separate disclosure of the date of approval of financial statements. Note that this date is important because it gives a clear idea to the stakeholders about the period, which is covered after the reporting period, for providing information to the stakeholders. In a way, it determines the scope of the financial statements in terms of time.

2.10.2 Updating disclosure about conditions at the end of the reporting period

- If an entity receives information after the reporting period about conditions that existed at the end of the reporting period, it shall update disclosures that relate to those conditions, in the light of the new information.

  In case of adjusting events, the entity is supposed to make the necessary adjustments in the financial statements. But just making the changes in the financial statements will not be sufficient as the stakeholders will not be in a position to understand why the adjustments are made. Therefore, in addition to adjustments in the financial statements, it is necessary to make the separate disclosure of the same.
- In some cases, an entity needs to update the disclosures in its financial statements to reflect information received after the reporting period, even when the information does not affect the amounts that it recognises in its financial statements. One example of the need to update

disclosures is when evidence becomes available after the reporting period about a contingent liability that existed at the end of the reporting period. In addition to considering whether it should recognise or change a provision under Ind AS 37, an entity updates its disclosures about the contingent liability in the light of that evidence.

2.10.3 Disclosure of Non-adjusting events after the reporting period

If non-adjusting events after the reporting period are material, non-disclosure could influence the economic decisions that users make on the basis of the financial statements. Accordingly, an entity shall disclose the following for each material category of non-adjusting event after the reporting period:

(a) the nature of the event; and

(b) an estimate of its financial effect, or a statement that such an estimate cannot be made.

Examples of non-adjusting events after the reporting period resulting in disclosure

(a) a major business combination after the reporting period Ind AS 103, Business Combinations, requires specific disclosures in such cases) or disposing of a major subsidiary;

(b) announcing a plan to discontinue an operation;

(c) major purchases of assets, classification of assets as held for sale in accordance with Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations, other disposals of assets, or expropriation of major assets by government;

(d) the destruction of a major production plant by a fire after the reporting period;

(e) announcing, or commencing the implementation of, a major restructuring (see Ind AS 37);

(f) major ordinary share transactions and potential ordinary share transactions after the reporting period (Ind AS 33, Earnings per Share, requires an entity to disclose a description of such transactions, other than when such transactions involve capitalisation or bonus issues, share splits or reverse share splits all of which are required to be adjusted under Ind AS 33);

(g) abnormally large changes after the reporting period in asset prices or foreign exchange rates;

(h) changes in tax rates or tax laws enacted or announced after the reporting period that have a significant effect on current and deferred tax assets and liabilities (see Ind AS 12, Income Taxes);

(i) entering into significant commitments or contingent liabilities, for example, by issuing significant guarantees; and

(j) commencing major litigation arising solely out of events that occurred after the reporting period.

2.11 DISTRIBUTION OF NON-CASH ASSETS TO OWNERS

Sometimes an entity distributes non-cash assets as dividends to its equity shareholders. An entity may also give equity shareholders a choice of receiving either non-cash assets or a cash alternative.

Ind AS 1 requires an entity to present details of dividends recognised as distributions to owners either in the statement of changes in equity or in the notes to the financial statements but does not prescribe how to measure it. Appendix A to Ind AS 10, Distribution of Non-cash Assets to Owners is relevant in this regard.

2.11.1 Applicability

- Appendix A to Ind AS 10 applies to the following types of non-reciprocal distributions of assets by an entity to its owners acting in their capacity as owners:
  - (a) distributions of non-cash assets (e.g., items of property, plant and equipment, businesses as defined in Ind AS 103, ownership interests in another entity or disposal groups as defined in Ind AS 105); and
  - (b) distributions that give owners a choice of receiving either non-cash assets or a cash alternative.
- It applies only to distributions in which all owners of the same class of equity instruments are treated equally.

2.11.2 Non-applicability

- This Appendix does not apply to a distribution of a non-cash asset that is ultimately controlled by the same party or parties before and after the distribution.
- This exclusion applies to the separate, individual and consolidated financial statements of an entity that makes the distribution.
- For a distribution to be outside the scope on the basis that the same parties control the asset both before and after the distribution, a group of individual shareholders receiving the distribution must have, as a result of contractual arrangements, such ultimate collective power over the entity making the distribution.
- It does not apply when an entity distributes some of its ownership interests in a subsidiary but retains control of the subsidiary. The entity making a distribution that results in the entity recognising a non-controlling interest in its subsidiary accounts for the distribution in accordance with Ind AS 110, Consolidated Financial Statements.

- This Appendix addresses only the accounting by an entity that makes a non-cash asset distribution. It does not address the accounting by shareholders who receive such a distribution.

2.11.3 Accounting Principles

When an entity declares a distribution and has an obligation to distribute the assets concerned to its owners, it must recognise a liability for the dividend payable.

2.11.3.1 When to recognise a dividend payable

The liability to pay a dividend shall be recognised when the dividend is appropriately authorised and is no longer at the discretion of the entity, which is the date:

(a) when declaration of the dividend, e.g., by management or the board of directors, is approved by the relevant authority, e.g., the shareholders, if the jurisdiction requires such approval, or

(b) when the dividend is declared, e.g., by management or the board of directors, if the jurisdiction does not require further approval.

2.11.3.2 Measurement of a dividend payable

- An entity shall measure a liability to distribute non-cash assets as a dividend to its owners at the fair value of the assets to be distributed.
- If an entity gives its owners a choice of receiving either a non-cash asset or a cash alternative, the entity shall estimate the dividend payable by considering both the fair value of each alternative and the associated probability of owners selecting each alternative.
- At the end of each reporting period and at the date of settlement, the entity shall review and adjust the carrying amount of the dividend payable, with any changes in the carrying amount of the dividend payable recognised in equity as adjustments to the amount of the distribution.

  Accounting for any difference between the carrying amount of the assets distributed and the carrying amount of the dividend payable when an entity settles the dividend payable.
- When an entity settles the dividend payable, it shall recognise the difference, if any, between the carrying amount of the assets distributed and the carrying amount of the dividend payable in profit or loss.

2.11.3.3 Presentation and disclosures

An entity shall present the difference between carrying amount of the assets distributed and the carrying amount of the dividend payable at the time of settlement of the dividend payable as a separate line item in profit or loss.

An entity shall disclose the following information, if applicable:

(a) the carrying amount of the dividend payable at the beginning and end of the period; and

(b) the increase or decrease in the carrying amount recognised in the period as result of a change in the fair value of the assets to be distributed.

If after the end of a reporting period but before the financial statements are approved for issue, an entity declares a dividend to distribute a non-cash asset, it shall disclose:

(a) the nature of the asset to be distributed;

(b) the carrying amount of the asset to be distributed as of the end of the reporting period; and

(c) the fair value of the asset to be distributed as of the end of the reporting period, if it is different from its carrying amount, and the information about the method(s)used to measure that fair value required to be disclosed by Ind AS 113, Fair Value Measurement.

2.12 SIGNIFICANT DIFFERENCES BETWEEN IND AS 10 AND AS 4

S. No	Particulars	Ind AS 10	AS 4
	Title	**Events after the Reporting Period**	**Contingencies and Events Occurring After the Balance Sheet Date**
1.	***Material non adjusting events***	The standard requires material non-adjusting events to be disclosed in the financial statements.	AS 4 requires the same to be disclosed in the report of approving authority.
2.	***Accounting treatment and disclosure in case of inappropriateness of fundamental accounting assumption of going concern***	If after the reporting date it is determined that the fundamental accounting assumption of going concern is no longer appropriate, Ind AS 10 requires a fundamental change in the basis of accounting.	AS 4 requires assets and liabilities to be adjusted for events occurring after the balance sheet date that indicate that the fundamental accounting assumption of going concern is not appropriate.
		In this regard, Ind AS 10 refers to Ind AS 1, which requires an entity to make the following disclosures: • disclose the fact that the financial statements are not prepared on a going concern basis together with the basis on which the financial statements are prepared. • state the reason why the entity is not regarded as a going concern.	AS 4 does not require any such disclosure. However, AS 1 requires the disclosure of the fact in case going concern assumption is not followed.

3.	***Breach of a material provision of a long-term loan arrangement***	Consequent to carve-out made in Ind AS 1, it has been provided in the definition of 'Events after the reporting period' that in case of breach of a material provision 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 on the reporting date, if the lender, before the approval of the financial statements for issue, agrees to waive the breach, it shall be considered as an adjusting event.	No such guidance is given in AS 4
4.	***Distribution of non-cash assets to owners***	Ind AS 10 includes an Appendix *Distribution of Non-cash Assets to Owners* which deals, inter alia, with when to recognise dividends payable to its owners.	No such guidance is given in AS 4

2.13 CARVE OUT IN IND AS 10 FROM IAS 10

As per IAS 10 Events after the Reporting Period: Rectification of any breach after the end of the reporting period is a non-adjusting event.

Carve Out: As a consequence to carve-out made in Ind AS 1, Ind AS 10 provides, in the definition of 'Events after the reporting period' that in case of breach of a material provision 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 on the reporting date, if the lender, before the approval of the financial statements for issue, agrees to waive the breach, it shall be considered as an adjusting event.

TEST YOUR KNOWLEDGE

Questions

1. ABC Ltd., has announced its interim results for Quarter 1, ending 30th June, 20X2 on 5th July, 20X2. However, till that time the AGM for the year 20X1-20X2 was not held. The financial statements for 20X1-20X2 were approved by the board of directors on 15th July, 20X2. What will be the 'after the reporting period' as per the definition given in Ind AS 10?

2. ABC Ltd., is in a legal suit with the GST department. The company gets a court order in its favour on 15th April, 20X2, which resulted into reducing the tax liability as on 31st March, 20X2. The financial statements for 20X1-20X2 were approved by the board of directors on 15th May, 20X2. The management has not considered the effect of the transaction as the event is favourable to the company. The company's view is that favourable events after the reporting period should not be considered as it would hamper the realisation concept of accounting. Comment on the company's views in the light of Ind AS 10.

3. ABC Ltd., is trading in laptops. On 31st March, 20X2, the company has 50 laptops which were purchased at ₹ 45,000 each. The company has considered the same price for calculation of closing inventory valuation. On 15th April, 20X2, advanced version of same series of laptops is introduced in the market. Therefore, the price of the current laptops crashes to ₹ 35,000 each. The financial statements for 20X1-20X2 were approved by the board of directors on 15th May, 20X2. The company does not want to value the stock at ₹ 35,000 less estimated costs necessary to make the sale as the event of reduction in selling price took place after 31st March, 20X2 and the reduced prices were not applicable as on 31st March, 20X2. Comment on the company's views.

4. XY Ltd had taken a large-sized civil construction contract, for a public sector undertaking, valued at Rs. 200 Crores. Execution of the project started during 20X1-X2, and continued in the next financial year also. During the course of execution of the work on May 29, 20X2, the company found while raising the foundation work that it had met a rocky surface and cost of contract would go up by an extra Rs. 50 crore, which would not be recoverable from the Contractee as per the terms of the contract. The Company's financial year ended on 31st March, 20X2, and the financial statements were considered and approved by the Board of Directors on 15th June, 20X2. How will you treat the above in the financial statements for the year ended 31st March, 20X2?

5. A Ltd. was required to pay penalty for a breach in the performance of a contract. A Ltd. believed that the penalty was payable at a lower amount than the amount demanded by the other party. A Ltd. created provision for the penalty but also approached the arbitrator with a submission that the case may be dismissed with costs. A Ltd. prepared the financial statements for the year 20X1-X2, which were approved in July 20X2. The arbitrator, in June 20X2, awarded the case in favour of A Ltd. As a result of the award of the arbitrator, the provision earlier made by

A Ltd. was required to be reduced. The arbitrator also decided that cost of the case should be borne by the other party. Now, whether A Ltd. is required to remeasure its provision and what would be the accounting treatment of the cost that will be recovered by A Ltd., which has already been charged to the Statement of Profit and Loss as an expense for the year 20X1-X2?

6. A company manufacturing and supplying process control equipment is entitled to duty drawback if it exceeds its turnover above a specified limit. To claim duty drawback, the company needs to file application within 15 days of meeting the specified turnover. If application is not filed within stipulated time, the Department has discretionary power of giving duty draw back credit. For the year 20X1-X2, the company has exceeded the specified limit of turnover by the end of the reporting period but the application for duty drawback is filed on April 20, 20X2, which is after the stipulated time of 15 days of meeting the turnover condition.

   Duty drawback has been credited by the Department on June 28, 20X2 and financial statements have been approved by the Board of Directors of the company on July 26, 20X2. Whether duty drawback credit should be treated as an adjusting event?

7. XYZ Ltd. sells goods to its customer with a promise to give discount of 5% on list price of the goods provided that the payments are received from customer within 15 days. XYZ Ltd. sold goods of Rs. 5 lakhs to ABC Ltd. between 17th March, 20X2 and 31st March, 20x2. ABC Ltd. paid the dues by 15th April, 20X2 with respect to sales made between 17th March, 20X2 and 31st March, 20X2. Financial statements were approved for issue by Board of Directors on 31st May, 20X2.

   State whether discount will be adjusted from the sales at the end of the reporting period.

8. Whether the fraud related to 20X1-X2 discovered after the end of the reporting period but before the date of approval of financial statements for 20X3-X4 is an adjusting event?

9. X Ltd. was having investment in form of equity shares in another company as at the end of the reporting period, i.e., 31st March, 20X2. After the end of the reporting period but before the approval of the financial statements it has been found that value of investment was fraudulently inflated by committing a computation error. Whether such event should be adjusted in the financial statements for the year 20X1-X2?

Answers

1. As per Ind AS 10, even if partial information has already been published, the reporting period will be considered as the period between the end of reporting period and the date of approval of financial statements. In the above case, the financial statements were approved on 15th July, 20X2. Therefore, for the purposes of Ind AS 10, 'after the reporting period' would be the period between 31st March, 20X2 and 15th July, 20X2.

2. As per Ind AS 10, even favourable events need to be considered. What is important is whether a condition exists as at the end of the reporting period and there is evidence for the same.

3. As per Ind AS 10, the decrease in the net realisable value of the stock after reporting period should normally be considered as an adjusting event.

4. In the instant case, the execution of work started during the F.Y. 20X1-X2 and the rocky surface was there at the end of the reporting period, though the existence of rocky surface is confirmed after the end of the reporting period as a result of which it became evident that the cost may escalate by Rs. 50 Crores. In accordance with the definition of 'Events after the Reporting Period', since the rocky surface was there, the condition was existing at the end of the reporting period, therefore, it is an adjusting event. The cost of the project and profit should be accounted for accordingly.

5. In the instant case, A Ltd. approached the arbitrator before the end of the reporting period, who decided the award after the end of the reporting period but before approval of the financial statements for issue. Accordingly, the conditions were existing at the end of the reporting date because A Ltd. had approached the arbitrator before the end of the reporting period whose outcome has been confirmed by the award of the arbitrator. Therefore, it is an adjusting event.

   Accordingly, the measurement of the provision is required to be adjusted for the event occurring after the reporting period. As far as the recovery of the cost by A Ltd. from the other party is concerned, this right to recover was a contingent asset as at the end of the reporting period.

   As per para 35 of Ind AS 37, contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs. If an inflow of economic benefits has become probable, an entity discloses the contingent asset.

   On the basis of the above, a contingent asset should be recognised in the financial statements of the period in which the realisation of asset and the related income becomes virtually certain. In the instant case, the recovery of cost became certain when the arbitrator decided the award during F.Y. 20X2-X3.

   Accordingly, the recovery of cost should be recognised in the financial year 20X2-X3.

6. In the instant case, the condition of exceeding the specified turnover was met at the end of the reporting period and the company was entitled for the duty draw back but the application for the same has been filed after the stipulated time. Therefore, credit of duty drawback is discretionary in the hands of the Department. Accordingly, the duty drawback credit is a contingent asset as at the end of the reporting period, which may be realised if the Department credits the same.

   As per para 35 of Ind AS 37, contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs. If an inflow of economic benefits has become probable, an entity discloses the contingent asset.

In accordance with the above, the duty draw back credit which was contingent asset for the F.Y. 20X1-X2 should be recognised as asset and related income should be recognized in the reporting period in which the change occurs. i.e., in the period in which realisation becomes virtually certain, i.e., F.Y. 20X2-X3.

7. As per Ind AS 115, if the consideration promised in a contract includes a variable amount, an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer.

   In the instant case, the condition that sales have been made exists at the end of the reporting period and the receipt of payment with 15 days time after the end of the reporting period and before the approval of the financial statements confirms that the discount is to be provided on those sales. Therefore, it is an adjusting event. Accordingly, XYZ Ltd. should adjust the sales made to ABC Ltd. with respect to discount of 5% on the list price of the goods.

8. In the instant case, the fraud is discovered after the end of the reporting period of 20X3-X4, which related to F.Y. 20X1-X2. Since the fraud has taken place before the end of the reporting period, the condition was existing which has been confirmed by the detection of the same after the end of the reporting period but before the approval of financial statements. Therefore, it is an adjusting event.

   Moreover, Ind AS 10 in paragraph 9, specifically provides that the discovery of fraud or error after the end of the reporting period, that shows that financial statements are incorrect, is an adjusting event. Such a discovery of fraud should be accounted for in accordance with Ind AS 8, if it meets the definition of prior period error.

9. Since it has been detected that a fraud has been made by committing an intentional error and as a result of the same financial statements present an incorrect picture, which has been detected after the end of the reporting period but before the approval of the financial statements. The same is an adjusting event. Accordingly, the value of investments in the financial statements should be adjusted for the fraudulent error in computation of value of investments.

UNIT 3: INDIAN ACCOUNTING STANDARD 7: STATEMENT OF CASH FLOWS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand the meaning of cash flow statement
- Describe the objective and scope of issuance of Ind AS 7
- Define the relevant terms used in the Ind AS
- Classify the types of cash flows into operating, investing and financing activities
- Distinguish between direct and indirect method of presentation of cash flows under the operating activity
- Identify the provision applicable to various peculiar situations of cash flows
- Disclose the necessary information as required in the standard
- Differentiate between Ind AS 7 and AS 3.

UNIT OVERVIEW

Ind AS 7	• Objectives • Scope • Benefits • Definitions
Presentation of Statement of Cash Flows	• Operating Cash Flows • Investing Cash Flows • Financing Cash Flows
Method of Presentation	• Direct Method • Indirect Method
Peculiar Cases of Cash flows	• Reporting on a net basis • Foreign Currency Transactions • Interest and Dividend • Taxes on Income • Investments in Subsidiaries, associates and Joint ventures • Changes in ownerships Interests in subsidiaries and other businesses • Non Cash Transactions
Discosure	• Components of cash and cash equivalents • Other Disclosures

3.1 INTRODUCTION

The balance sheet is a snapshot of entity's financial resources and obligations at a particular point of time and the statement of profit and loss reflects the financial performance for the period. These two components of financial statements are based on accrual basis of accounting. The statement of cash flows includes only inflows and outflows of cash and cash equivalents; it excludes transactions that do not affect cash receipts and payments.

The information on cash flows is useful in assessing sources of generating and deploying cash and cash equivalents during the reporting period. The statement of cash flows can be used for comparison with earlier reporting periods of the same entity as well as comparison with other entities for the same reporting period.

Ind AS 7, Statement of Cash Flows, prescribes principles and guidance on preparation and presentation of cash flows of an entity from operating activities, investing activities and financing activities for a reporting period.

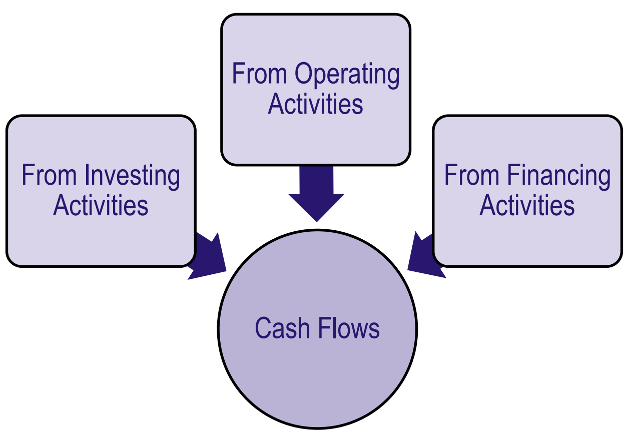
3.2 MEANING OF STATEMENT OF CASH FLOWS

Cash flow statement, in simple words is a statement, which provides the details about how the cash is generated by an entity during the particular reporting period and how it is applied. While doing so, it takes into consideration the opening balances of cash and cash equivalents, adds the cash generated, deducts the cash payments and reconciles it with closing balances of cash and cash equivalents. The cash flows are classified into following three main categories:

(a) Cash flows from Operating Activities

(b) Cash flows from Investing Activities

(c) Cash flows from Financing Activities



The simplified example of cash flow statement, for understanding purpose is given below

Particulars	Amount (₹)
Cash flow from Operations Activities	10,000
Cash flow from Investing Activities	(2,000)
Cash flow from Financing Activities	(4,000)
Net Cash Generated during the year	4,000
Add: Cash and Cash Equivalents at the beginning of the year	13,000
Cash and Cash Equivalents at the end of the year (which will also tally with the cash and cash equivalents given in the balance sheet)	17,000

Thus, one can see that at the beginning of the year, the **opening balance** of cash and cash equivalent was ₹ 13,000. During the year, the business **generated (inflow)** cash from its main operations ₹ 10,000. Thus, the entity had ₹ 23,000 at its disposal. Out of it, the entity has **used (outflow)** ₹ 2,000 for additional investments and ₹ 4,000 for financing activities. Therefore, at the end of the year, the entity is left with the balance of ₹ 17,000.

3.3 OBJECTIVE

Ind AS 7, has specified the following objectives of Statement of Cash Flows:

3.3.1 To provide information about historical changes in cash and cash equivalents

Cash flow statement aims at providing the information about how the cash has been generated during the year and for what purposes has it been utilised. The information will be provided for current year and immediate previous year.

3.3.2 To assess the ability to generate cash and cash equivalents

Cash flow statement is intended to provide the stakeholders about the efficiency of the company in generating cash and cash equivalents. Some companies may look profitable as per profit and loss account but whether they have enough cash for payment of their debts and creditors has to be assessed by using cash flow statement.

3.3.3 To understand the timing and certainty of their generation

The historical analysis of statement of cash flow can set a trend regarding the years in which company could generate fair amount of cash flows and the probability of generating it.

3.4 BENEFITS OF CASH FLOW INFORMATION

3.4.1 Provides information enabling evaluation of changes in net assets and financial structure (Liquidity and solvency)

Cash flow statement reconciles the opening balances of cash and cash equivalents with the closing balances of cash and cash equivalents, giving the reasons for the changes happened during the year. Thus it provides a clear picture of cash inflows and out flows that have taken place during the reporting period.

3.4.2 Assesses the ability to manage the cash

The stakeholders get an idea about what is the source of generation of cash and how it is used for. The information gives a fair idea about the efficiency and ability of the company to generate cash.

For example, suppose there is negative cash flow from operations. It denotes that company is unable to generate cash from its main business activity, which is not a favourable situation.

Cash flow statements can also throw light on whether company could generate sufficient cash or not.

For example, company wants to expand its production capacity. The cash flow statement can indicate whether company could generate the required cash from their operations, or whether company has generated the funds from share capital or whether company has taken a loan for the same.

3.4.3 Assess and compare the present value of future cash flows

The past trends of cash flows will help the company to predict about future cash flows. Such information is useful while evaluating the projects on capital budgeting or valuation of shares. Thus it forms the base for future projects and can be discounted using discounting techniques.

3.4.4 Compares the efficiency of different entities

Accounting profits of various entities may have different assumptions, policies and definitions. However, cash flows will be calculated by using the same technique and finally all differing assumptions across the companies will melt down and entity will reach to a common comparable base of cash and cash equivalents.

3.5 SCOPE

An entity shall prepare a statement of cash flows in accordance with the requirements of this Standard and shall present it as an integral part of its financial statements for each period for which financial statements are presented.

The Standard requires all entities to present a statement of cash flows.

Every organisation, whether it is small or big in size, whether it's a manufacturing organisation or trading concern or service organisation, needs cash for running its business. The cash is also needed for future investments. Cash would be needed for payment of dividends, repayment of loans as well. Thus any organisation is required to generate the cash and utilises cash continuously.

Banks and Financial institutions are also not an exception to the same. Even if they deal with financial products, accept deposits and give loans day in and day out, they need to generate the cash profit for their own organisation. They need to make investments in terms of new branches, set ups etc. Thus statement of cash flow is equally important for Banking and Financial Institutions as well.

3.6 DEFINITIONS

The following terms are used in this Standard with the meanings specified:

1. ***Cash*** comprises cash on hand and demand deposits.
2. ***Cash equivalents*** are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.
3. ***Cash flows*** are inflows and outflows of cash and cash equivalents.
4. ***Operating activities*** are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.
5. ***Investing activities*** are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.
6. ***Financing activities*** are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

3.7 CASH AND CASH EQUIVALENTS

Cash Equivalent means investments which can be realised easily in cash in a short period from the date of investing the same.

1. **Purpose:** Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes.
2. **Liquidity and Risk :** For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the **date of acquisition**.

3. **Equity investments** are excluded from cash equivalents unless they are, in substance, cash equivalents.

4. **Bank borrowings** are generally considered to be financing activities. However, the bank overdrafts are an integral part of an entity's cash management, bank overdrafts are included as a component of cash and cash equivalents. A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn. Further, it is important to note that the bank overdraft due to issuance of cheques at the end of the cut-off period is not a part of cash and cash equivalent.

5. **Cash Management:** Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an entity rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents.

Illustration 1

Company has provided the following information regarding the various assets held by company on 31st March 20X1. Find out, which of the following items will be part of cash and cash equivalents for the purpose of preparation of cash flow statement as per the guidance provided in Ind AS 7:

Sr. No.	*Name of the Security*	*Additional Information*
1.	*Fixed deposit with SBI*	*12%, 3 years maturity on 1st Jan 20X4*
2.	*Fixed deposit with HDFC*	*10%, original term was for 2 years, but due for maturity on 30.06.20X1*
3.	*Redeemable Preference shares in ABC ltd*	*Acquired on 29th January 20X1 and the redemption is due on 30th April 20X1*
4.	*Cash balances at various banks*	*All branches of all banks in India*
5.	*Cash balances at various banks*	*All international branches of Indian banks*
6.	*Cash balances at various banks*	*Branches of foreign banks outside India*
7.	*Bank overdraft of SBI Fort branch*	*Temporary overdraft, which is payable on demand*
8.	*Treasury Bills*	*90 days maturity*

Solution

Sr. No.	Name of the Security	Decision
1.	Fixed deposit with SBI	Not to be considered – long term
2.	Fixed deposit with HDFC	Exclude as original maturity is not less than 90 days from the date of acquisition
3.	Redeemable Preference shares in ABC Ltd.	Include as due within 90 days from the date of acquisition
4.	Cash balances at various banks	Include
5.	Cash balances at various banks	Include
6.	Cash balances at various banks	Include
7.	Bank overdraft of SBI Fort branch	Include
8.	Treasury Bills	Include

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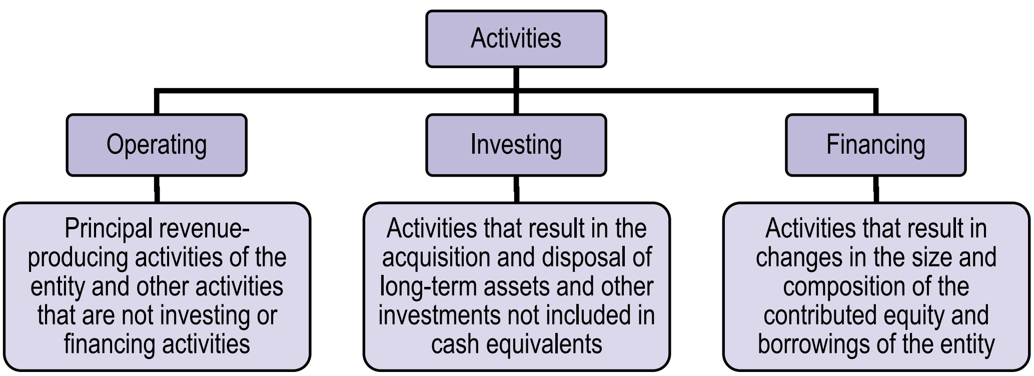
3.8 PRESENTATION OF STATEMENT OF CASH FLOWS

The statement of cash flows shall report cash flows during the period classified by operating, investing and financing activities.



3.8.1 Operating Activities

- Cash flows from operating activities are primarily derived from the principal revenue producing activities of the entity ie from operations of the business. Therefore, they are, in general, the result of the transactions and events that enter into the determination of profit or loss.

Examples of cash flows from operating activities are:

Operating Cash Inflows	Operating Cash Outflows
Cash receipts from the sale of goods and the rendering of services	Cash payments to suppliers for goods and services
Cash receipts from royalties, fee, commission and other revenue	Cash payments to and on behalf of employees
Cash receipts and cash payments of an insurance entity for premiums and claims, annuities and other policy benefits	Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities
Cash receipts and payments from contracts held for dealing or trading purposes	

Illustration 2

From the following transactions, identify which transactions will be qualified for the calculation of operating cash flows, if company is into the business of trading of mobile phones

Sr. No.	*Nature of Transaction*
1	*Receipt from sale of mobile phones*
2	*Purchases of mobile phones from various companies*
3	*Employees expenses paid*
4	*Advertisement expenses paid*
5	*Credit sales of mobile*
6	*Misc. charges received from customers for repairs of mobiles*
7	*Loss due to decrease in market value of the closing stock of old mobile phones*
8	*Payment to suppliers of mobile phones*
9	*Depreciation on furniture of sales showrooms*
10	*Interest paid on cash credit facility of the bank*
11	*Profit on sale of old computers and printers, in exchange of new laptop and printer*
12	*Advance received from customers*
13	*Sales Tax and excise duty paid*

Solution

Sr. No.	Nature of Transaction	Included / Excluded with reason
1	Receipt from sale of mobile phones	Include – main revenue generating activity
2	Purchases of mobile phones from various companies	Include – expenses related to main operations of business
3	Employees expenses paid	Include – expenses related to main operations of business
4	Advertisement expenses paid	Include – expenses related to main operations of business
5	Credit sales of mobile	Do not include – Credit transaction will not be included in cash flow (receipts from customers will be included)
6	Misc. charges received from customers for repairs of mobiles	Include – supplementary revenue generating activity
7	Loss due to decrease in market value of the closing stock of old mobile phones	Do not include - Non cash transaction
8	Payment to suppliers of mobile phones	Include – cash outflow related to main operations of business
9	Depreciation on furniture of sales showrooms	Do not include – non cash item
10	Interest paid on cash credit facility of the bank	Do not include – cost of finance
11	Profit on sale of old computers and printers, in exchange of new laptop and printer	Do not include – non cash item
12	Advance received from customers	Include – Related to operations of business
13	Sales tax and excise duty paid	Include – related to operations of business

*****

- The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the entity have generated sufficient cash flows or not. If the cash flow from operations is positive, it will be treated as positive indicator whereas negative cash flow from operations will denote that company's ability to generate the revenue from its main operations is very weak. The companies in the initial stage of their business or the companies which are facing economic problems will generally have the negative cash flow from operations.

- Cash flow from operations are used to maintain the operating capability of the entity, pay dividends and make new investments without recourse to external sources of financing. Therefore, it is necessary to assess how much cash is generated by the business from operations? Are they sufficient to take care of their future investment plans? Can loans be repaid in time without default from such cash flows? Is there sufficient amount for payment of preference dividend? Is anything left for equity shareholders after making all these payments? Answers to all these questions will depend on whether the entity has generated enough cash or not.

3.8.1.1 Certain Specific Issues

1. **Profit / Loss on Sale of Assets :** Some transactions, such as the sale of an item of plant, may give rise to a gain or loss that is included in recognised profit or loss. The cash flows relating to such transactions are cash flows from investing activities.

2. **Properties built for let out :** Cash payments to manufacture or acquire assets held for rental to others and subsequently held for sale are cash flows from operating activities. The cash receipts from rents and subsequent sales of such assets are also cash flows from operating activities.

3.8.2 Investing Activities

Investment means sacrifice of current resource in a view to get more returns in future. All entities need some amount of investment for their future survival.

Ind AS 7 states that investing activities represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Only expenditures that result in a recognized asset in the balance sheet are eligible for classification as investing activities.

Examples of cash flows arising from investing activities are:

Cash Inflow from Investing Activities	Cash Outflow from Investing Activities
Cash receipts from sales of property, plant and equipment, intangibles and other long-term assets	Cash payments to acquire property, plant and equipment, intangibles and other long-term assets. These payments include those relating to capitalised development costs and self-constructed property, plant and equipment
Cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for dealing or trading purposes)	Cash payments to acquire equity or debt instruments of other entities and interests in joint ventures (other than payments for those instruments considered to be cash equivalents or those held for dealing or trading purposes);

Cash receipts from the repayment of advances and loans made to other parties (other than advances and loans of a financial institution)	Cash advances and loans made to other parties (other than advances and loans made by a financial institution)
Cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities	Cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities

When a contract is accounted for as a hedge of an identifiable position the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

Illustration 3

From the following transactions taken from a private sector bank operating in India, identify which transactions will be classified as operating and which would be classified as Investing activity.

S. No.	*Nature of transaction paid*
1	*Interest received on loans*
2	*Interest paid on Deposits*
3	*Deposits accepted*
4	*Loans given to customers*
5	*Loans repaid by the customers*
6	*Deposits repaid*
7	*Commission received*
8	*Lease rentals paid for various branches*
9	*Service tax paid*
10	*Furniture purchased for new branches*
11	*Implementation of upgraded banking software*
12	*Purchase of shares in 100% subsidiary for opening a branch in Abu Dhabi*
13	*New cars purchased from Honda dealer, in exchange of old cars*
14	*Provident fund paid for the employees*
15	*Issued employee stock options*

Solution

Sr. No.	Nature of transaction paid	Operating / Investing / Not to be considered
1	Interest received on loans	Operating – Main revenue generating activity

2	Interest paid on Deposits	Operating – Main expenses of operations
3	Deposits accepted	Operating – in case of financial institutes
4	Loans given to customers	Operating – in case of financial institutes
5	Loans repaid by the customers	Operating – in case of financial institutes
6	Deposits repaid	Operating – in case of financial institutes
7	Commission received	Operating – Main revenue generating activity
8	Lease rentals paid for various branches	Operating – Main expenses of operations
9	Service tax paid	Operating – Main expenses of operations
10	Furniture for new branches	Investing – Assets purchased
11	Implementation of upgraded banking software	Investing – Purchased for long term purpose
12	Purchase of shares in 100% subsidiary for opening a branch in Abu Dhabi	Investing – strategic investment
13	New cars purchased from Honda dealer, in exchange of old cars	Investing
14	Provident fund paid for the employees	Operating
15	Issued employee stock options	Not to be considered. No cash flow

*****

3.8.3 Financing Activities

During the life time of the entity, it needs money for long term investments as well as for working capital purpose. Company can raise the capital by way of equity or loans. Thus the cash flows related to raising of funds and redemption of funds will be covered under Cash flows from financing activities. The cost of capital is also generally covered under the Financing Activity.

Ind AS 7 states that the cash flows from Financing activity are useful in predicting claims on future cash flows by providers of capital to the entity.

Cash Inflows from Financing Activity	Cash Outflows from Financing Activity
Cash proceeds from issuing shares or other equity instruments;	Cash payments to owners to acquire or redeem the entity's shares;

Cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other	Cash repayments of amounts borrowed; and
Short-term or long-term borrowings;	Cash payments by a lessee for the reduction of the outstanding liability relating to a lease.

Illustration 4

From the following transactions taken from a parent company having multiple businesses and multiple segments, identify which transactions will be classified as operating Investing and Financing:

Sr. No.	*Nature of transaction*
1	*Issued preference shares*
2	*Purchased the shares of 100% subsidiary company*
3	*Dividend received from shares of subsidiaries*
4	*Dividend received from other companies*
5	*Bonus shares issued*
6	*Purchased license for manufacturing of special drugs*
7	*Royalty received from the goods patented by the company*
8	*Rent received from the let out building (letting out is not main business)*
9	*Interest received from the advances given*
10	*Dividend paid*
11	*Interest paid on security deposits*
12	*Purchased goodwill*
13	*Acquired the assets of a company by issue of equity shares (not parting any cash)*
14	*Interim dividends paid*
15	*Dissolved the 100% subsidiary and received the amount in final settlement*

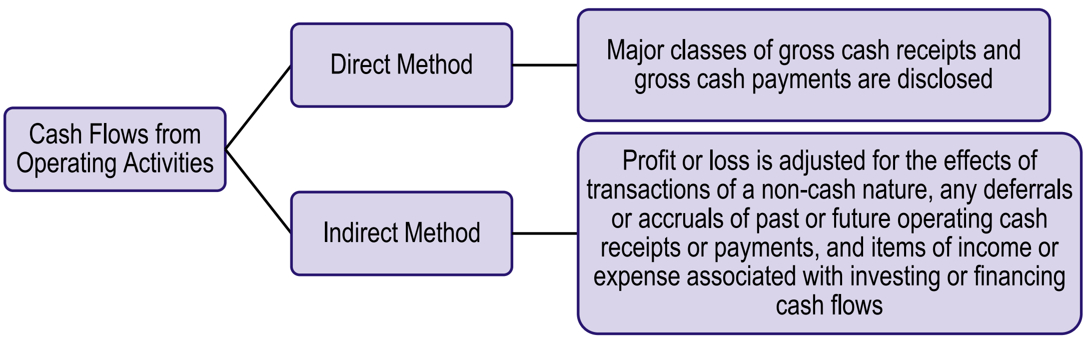
Solution

Sr. No.	Nature of transaction	Operating / Investing / Financing /Not to be considered
1	Issued preference shares	Financing
2	Purchased the shares of 100% subsidiary company	Investing
3	Dividend received from shares of subsidiaries	Investing
4	Dividend received from other companies	Investing
5	Bonus shares issued	No cash flow

6	Purchased license for manufacturing of special drugs	Investing
7	Royalty received from the goods patented by the company	Operating
8	Rent received from the let out building (letting out is not main business)	Investing
9	Interest received from the advances given	Operating
10	Dividend paid	Financing
11	Interest paid on security deposits	Financing
12	Purchased goodwill	Investing
13	Acquired the assets of a company by issue of equity shares (not parting any cash)	Not to be considered
14	Interim dividends paid	Financing
15	Dissolved the 100% subsidiary and received the amount in final settlement	Investing

*****

3.9 REPORTING CASH FLOWS FROM OPERATING ACTIVITIES



- An entity shall report cash flows from operating activities using either:

  (a) the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or

  (b) the indirect method, whereby profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

- Entities are encouraged to report cash flows from operating activities using the direct method. The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method. Under the direct method, information about major classes of gross cash receipts and gross cash payments may be obtained either:

(a) from the accounting records of the entity; or

(b) by adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial institution) and other items in the statement of profit and loss for:

  (i) changes during the period in inventories and operating receivables and payables;

  (ii) other non-cash items; and

  (iii) other items for which the cash effects are investing or financing cash flows.

Analysis

Direct method starts with cash revenue/income/ receipts of the company. All the cash expenses will be deducted from such cash revenue. The cash profit will be adjusted for the cash flows arising from investing and financing activities. Non-cash expenses/losses/gains will not be considered. The payments to suppliers and receipts from customers are also taken into consideration. The resultant figure would cash flow from operating activity. The exercise would be similar to converting the income and expenditure account (accrual system) into receipt and payment (cash system), with the difference effects on investments and liabilities will not be considered. Thus if we consider the vertical operating statement, direct method will have (TOP down) approach of presentation.

- Under the indirect method, the net cash flow from operating activities is determined by adjusting profit or loss for the effects of:

(a) changes during the period in inventories and operating receivables and payables;

(b) non-cash items such as depreciation, provisions, deferred taxes, unrealised foreign currency gains and losses, and undistributed profits of associates; and

(c) all other items for which the cash effects are investing or financing cash flows.

Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing the revenues and expenses disclosed in the statement of profit and loss and the changes during the period in inventories and operating receivables and payables.

Analysis

Indirect method is reverse of direct method. It starts with the accounting profit after tax as given in profit and loss accounts. Thereafter, the profit will be adjusted for non-cash items, losses and gains on investing and financing activities, interest and dividends, collection and payments to debtors/creditors etc. Accordingly, the cash from operating activity will derived. Thus indirect method will have (Bottom up) approach.

Note: Under both the methods the amount of cash flow from Operating activities need to be necessarily same. It's only the approach for presentation which differs.

Illustration 5

Find out the cash from operations by direct method and indirect method from the following information:

Operating statement of ABC Ltd. for the year ended 31.3.2017

Particulars	₹
Sales	5,00,000.00
Less: Cost of goods sold	3,50,000.00
Administration & Selling Overheads	55,000.00
Depreciation	7,000.00
Interest Paid	3,000.00
Loss on sale of asset	2,000.00
Profit before tax	83,000.00
Tax	(30,000.00)
Profit After tax	**53,000.00**

Balance Sheet as on 31st March

	2017	2016
Assets		
Non-current Assets		
Property, Plant and Equipment	75,000.00	65,000.00
Investment	12,000.00	10,000.00
Current Assets		
Inventories	12,000.00	13,000.00
Trade receivables	10,000.00	7,000.00
Cash and cash equivalents	6,000.00	5,000.00
Total	**1,15,000.00**	**1,00,000.00**
Equity and Liabilities		
Shareholders' Funds	60,000.00	50,000.00
Non-current Liabilities	25,000.00	30,000.00

Current Liabilities		
Trade Payables	*12,000.00*	*8,000.00*
Payables for Expenses	*10,000.00*	*7,000.00*
Provisions	*8,000.00*	*5,000.00*
Total	***1,15,000.00***	***1,00,000.00***

Solution

1. Cash flow from Operations by Direct Method

Particulars	₹	See Note
Cash Sales	4,97,000.00	1
Less: Cash Purchases	3,45,000.00	2
Overheads	52,000.00	3
Interest	-	Financing
Depreciation	-	Non cash item
Loss	-	Non cash item
Cash profit	**100,000.00**	
Less: Tax	(30,000.00)	
Cash profit after tax	**70,000.00**	

Note No 1 - Cash Receipts from Sales and Trade receivables

Particulars	₹	
Sales	500,000.00	
Add : Opening Trade receivables	7,000.00	
Less : Closing Trade receivables	(10,000.00)	
Cash Receipts	**497,000.00**	

Note No 2 :- Payment to Trade Payables for Purchases

Particulars	₹	
Cost of goods sold	350,000.00	
Closing inventories	12,000.00	
Less: Opening inventories	(13,000.00)	
Purchases	349,000.00	
Add: Opening Trade Payables	8,000.00	
Less: Closing Trade Payables	(12,000.00)	

Payment to creditors	**345,000.00**	
Note No 3 :- Payment to payables for Expenses		
Particulars	**₹**	
Overheads	55,000.00	
Add: Opening payables	7,000.00	
Less: Closing payables	(10,000.00)	
Payment for Overheads	**52,000.00**	

2. Cash flow from Operations by Indirect Method

Indirect Method	₹
Profit After Tax	53,000.00
Add/(Less) : Depreciation	7,000.00
Loss on Asset	2,000.00
Interest paid	3,000.00
Decrease in Inventory	1,000.00
Increase in Trade Receivables	(3,000.00)
Increase in Trade Payables	4,000.00
Increase in Payables for expenses	3,000.00
Total	**70,000.00**

Note: Cash flow derived from operations ₹ 70,000 is same both from Direct Method and Indirect Method.

*****

3.10 REPORTING CASH FLOWS FROM INVESTING AND FINANCING ACTIVITIES

An entity is required to report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except to the extent that cash flows are permitted to be reported on a net basis.

3.11 REPORTING CASH FLOWS ON A NET BASIS

If nothing is specifically mentioned, then as per Ind AS 7, the cash flows will be presented on Gross Basis. Gross basis means the receipts would be shown separately and the payments will be shown separately.

Example:

If in the year 20X1-20X2, some land is purchased for ₹ 2.5 crores and another land is sold for ₹ 3.5 crores then while presenting the information, entity shall show separately outflow of ₹ 2.5 crores and inflow of ₹ 3.5 crores.

The above base has following exceptions

1. Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:

   (a) cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the entity;

   Examples of cash receipts and payments referred to in paragraph 22(a) are:

   - the acceptance and repayment of demand deposits of a bank;
   - funds held for customers by an investment entity; and
   - rents collected on behalf of, and paid over to, the owners of properties.

   (b) Cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.

   Examples of cash receipts and payments referred to in paragraph 22(b) are advances made for, and the repayment of:

   - principal amounts relating to credit card customers;
   - the purchase and sale of investments; and
   - other short-term borrowings, for example, those which have a maturity period of three months or less.

2. Cash flows arising from each of the following activities of a financial institution may be reported on a net basis:

   (a) cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date;

   (b) the placement of deposits with and withdrawal of deposits from other financial institutions; and

(c) cash advances and loans made to customers and the repayment of those advances and loans.

3.12 FOREIGN CURRENCY CASH FLOWS

- Cash flows arising from transactions in a foreign currency shall be recorded in an entity's functional currency by applying to the foreign currency amount the exchange rate between the functional currency and the foreign currency at the date of the cash flow.
- The cash flows of a foreign subsidiary shall be translated at the exchange rates between the functional currency and the foreign currency **at the dates of the cash flows**.

Example:

Suppose the money is received on account of exports on 15th January 2017 in US $. The company prepares the accounts in rupees. In such case the exchange rate between USD and Rupee as on 15th January 2017 need to be applied for conversion.

- Unrealised gains and losses arising from changes in foreign currency exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the statement of cash flows in order to reconcile cash and cash equivalents at the beginning and the end of the period. This amount is presented separately from cash flows from operating, investing and financing activities and includes the differences, if any, had those cash flows been reported at end of period exchange rates.

3.13 INTEREST AND DIVIDENDS

Cash flows from interest and dividends received and paid shall each be disclosed separately.

	Financing company	Other company
Interest paid	Cash flows arising from operating activities	Cash flows from financing activities
Interest and dividends received	Cash flows arising from operating activities	Cash flows from investing activities
Dividends paid	Cash flows from financing activities	Cash flows from financing activities

Illustration 6

A firm invests in a five-year bond of another company with a face value of ₹ 10,00,000 by paying ₹ 5,00,000. The effective rate is 15%. The firm recognises proportionate interest income in its income statement throughout the period of bond.

Based on the above information answer the following question:

a) How the interest income will be treated in cash flow statement during the period of bond?

b) On maturity, whether the receipt of ₹ 10,00,000 should be split between interest income and receipts from investment activity.

Solution

Interest Income will be treated as income over the period of bond in the income statement. However, there will be no cash flow in these years because no cash has been received. On maturity, receipt of ₹ 10,00,000 will be classified as investment activity with a bifurcation of interest income & money received on redemption of bond.

*****

3.14 TAXES ON INCOME

Cash flows arising from taxes on income shall be separately disclosed and shall be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

Taxes on income arise on transactions that give rise to cash flows that are classified as operating, investing or financing activities in a statement of cash flows. While tax expense may be readily identifiable with investing or financing activities, the related tax cash flows are often impracticable to identify and may arise in a different period from the cash flows of the underlying transaction. Therefore, taxes paid are usually classified as cash flows from operating activities. However, when it is practicable to identify the tax cash flow with an individual transaction that gives rise to cash flows that are classified as investing or financing activities the tax cash flow is classified as an investing or financing activity as appropriate.

Illustration 7

X Limited has paid an advance tax amounting to ₹ 5,30,000 during the current year. Out of the above paid tax, ₹ 30,000 is paid for tax on long term capital gains.

Under which activity the above said tax be classified in the cash flow statements of X Limited?

Solution

Cash flows arising from taxes on income should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities. In the case of X Limited, the tax amount of ₹ 30,000 is specifically related with investing activities.

₹ 5,00,000 to be shown under operating activities. ₹ 30,000 to be shown under investing activities.

*****

3.15 INVESTMENTS IN SUBSIDIARIES, ASSOCIATES AND JOINT VENTURES

When accounting for an investment in an associate, a joint venture or a subsidiary accounted for by use of the equity or cost method, an investor restricts its reporting in the statement of cash flows to the cash flows between itself and the investee, for example, to dividends and advances.

An entity that reports its interest in an associate or a joint venture using the equity method includes in its statement of cash flows the cash flows in respect of its investments in the associate or joint venture, and distributions and other payments or receipts between it and the associate or joint venture.

3.16 CHANGES IN OWNERSHIPS INTERESTS IN SUBSIDIARIES AND OTHER BUSINESSES

3.16.1 Classification of Cash Flows as Investing Activity

- The aggregate cash flows arising from obtaining or losing control of subsidiaries or other businesses shall be presented separately and classified as investing activities.
- An entity shall disclose, in aggregate, in respect of both obtaining and losing control of subsidiaries or other businesses during the period each of the following:
  (a) the total consideration paid or received;
  (b) the portion of the consideration consisting of cash and cash equivalents;
  (c) the amount of cash and cash equivalents in the subsidiaries or other businesses over which control is obtained or lost; and
  (d) the amount of the assets and liabilities other than cash or cash equivalents in the subsidiaries or other businesses over which control is obtained or lost, summarised by each major category.
- The separate presentation of the cash flow effects of obtaining or losing control of subsidiaries or other businesses as single line items, together with the separate disclosure of the amounts of assets and liabilities acquired or disposed of, helps to distinguish those cash flows from the cash flows arising from the other operating, investing and financing activities. The cash flow effects of losing control are not deducted from those of obtaining control.
- The aggregate amount of the cash paid or received as consideration for obtaining or losing control of subsidiaries or other businesses is reported in the statement of cash flows net of

cash and cash equivalents acquired or disposed of as part of such transactions, events or changes in circumstances.

3.16.2 Classification of Cash Flows as Financing Activity

- Cash flows arising from changes in ownership interests in a subsidiary that do not result in a loss of control shall be classified as cash flows from financing activities, unless the subsidiary is held by an investment entity and is required to be measured at fair value through profit or loss.
- Changes in ownership interests in a subsidiary that do not result in a loss of control, such as the subsequent purchase or sale by a parent of a subsidiary's equity instruments, are accounted for as equity transactions (see Ind AS 110), unless the subsidiary is held by an investment entity and is required to be measured at fair value through profit or loss. Accordingly, the resulting cash flows are classified in the same way as other transactions with owners.

3.17 NON-CASH TRANSACTIONS

- Investing and financing transactions that do not require the use of cash or cash equivalents shall be excluded from a statement of cash flows.
- Such transactions shall be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.
- Many investing and financing activities do not have a direct impact on current cash flows although they do affect the capital and asset structure of an entity. Such non-cash items will not form part of the cash flow statement.

  Examples of non-cash transactions are:

  (a) the acquisition of assets either by assuming directly related liabilities or by means of a lease;

  (b) the acquisition of an entity by means of an equity issue; and

  (c) the conversion of debt to equity

Illustration 8

X Limited acquires fixed asset of ₹ 10,00,000 from Y Limited by accepting the liabilities of ₹ 8,00,000 of Y Limited and balance amount it paid in cash. How X Limited will treat all those items in its cash flow statements?

Solution

Investing and financing transactions that do not require the use of cash and cash equivalents shall be excluded from a statement of cash flows. X Limited should classify cash payment of ₹ 2,00,000 under investing activities. The non-cash transactions – liabilities and asset should be disclosed in the notes to the financial statements.

*****

3.17.1 Changes in liabilities arising from financing activities

- An entity shall provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes.
- To the extent necessary to satisfy the above requirement, an entity shall disclose the following changes in liabilities arising from financing activities:

  (a) changes from financing cash flows;

  (b) changes arising from obtaining or losing control of subsidiaries or other businesses;

  (c) the effect of changes in foreign exchange rates;

  (d) changes in fair values; and

  (e) other changes.
- Liabilities arising from financing activities are liabilities for which cash flows were, or future cash flows will be, classified in the statement of cash flows as cash flows from financing activities.
- In addition, the disclosure requirement also applies to changes in financial assets (for example, assets that hedge liabilities arising from financing activities) if cash flows from those financial assets were, or future cash flows will be, included in cash flows from financing activities.
- One way to fulfil the disclosure requirement is by providing a reconciliation between the opening and closing balances in the balance sheet for liabilities arising from financing activities, including the changes identified.
- If an entity provides the disclosure required in combination with disclosures of changes in other assets and liabilities, it shall disclose the changes in liabilities arising from financing activities separately from changes in those other assets and liabilities.

3.18 COMPONENTS OF CASH AND CASH EQUIVALENTS

- An entity shall disclose the components of cash and cash equivalents and shall present a reconciliation of the amounts in its statement of cash flows with the equivalent items reported in the balance sheet.
- Company will provide a policy which it adopts in determining the composition of cash and cash equivalents (As per Ind AS 1).

It has been clarified, that there should not be a difference in the amount of cash and cash equivalent as per Ind AS 1 and as per Ind AS 7. However, as per Ind AS 7 "where bank overdrafts which are repayable on demand form an integral part of an entity's cash management, bank overdrafts are included as a component of cash and cash equivalents. A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn." Although Ind AS 7 permits bank overdrafts to be included as cash and cash equivalent, for the purpose of presentation in the balance sheet, it would not be appropriate to include bank overdraft in the line item cash and cash equivalents unless the netting off conditions as given in paragraph 42 of Ind AS 32, Financial Instruments: Presentation are complied with.

Bank overdraft, in the balance sheet, will be included within financial liabilities. Just because the bank overdraft is included in cash and cash equivalents for the purpose of Ind AS 7, does not mean that the same should be netted off against the cash and cash equivalent balance in the balance sheet. Instead Ind AS 7 requires a disclosure of the components of cash and cash equivalent and a reconciliation of amounts presented in the cash flow statements.

Another element on account of which there could be difference between the cash and cash equivalents presented in the balance sheet and the statement of cash flows is unrealised gains or losses arising from changes in foreign currency exchange rates, which are not considered to be cash flows. The following illustration would explain the issue:

Illustration 9

An entity has bank balance in foreign currency aggregating to USD 100 (equivalent to ₹ 4,500) at the beginning of the year. Presuming no other transaction taking place, the entity reported a profit before tax of ₹ 100 on account of exchange gain on the bank balance in foreign currency at the end of the year. What would be the closing cash and cash equivalents as per the balance sheet?

Solution

For the purpose of statement of cash flows, the entity shall present the following:

	Amount (₹)
Profit before tax	100
Less: Unrealised exchange gain	(100)
Cash flow from operating activities	Nil
Cash flow from investing activities	Nil
Cash flow from financing activities	Nil
Net increase in cash and cash equivalents during the year	Nil
Add: Opening balance of cash and cash equivalents	4,500

Cash and cash equivalents as at the year-end	4,500
Reconciliation of cash and cash equivalents	
Cash and cash equivalents as per statement of cash flows	4,500
Add: Unrealised gain on cash and cash equivalents	100
Cash and cash equivalents as per the balance sheet	4,600

If any changes in the policies take place, that will be dealt with as per the provisions of Ind AS 8.

*****

3.19 OTHER DISCLOSURES

An entity shall disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the entity that are not available for use by the group.

There are various circumstances in which cash and cash equivalent balances held by an entity are not available for use by the group. Examples include cash and cash equivalent balances held by a subsidiary that operates in a country where exchange controls or other legal restrictions apply when the balances are not available for general use by the parent or other subsidiaries.

Additional information may be relevant to users in understanding the financial position and liquidity of an entity. It may include:

1. The amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities.
2. The aggregate amount of cash flows that represent increases in operating capacity separately from those cash flows that are required to maintain operating capacity it will help the stakeholders to know whether entity is paying proper attention for maintenance also;
3. The amount of the cash flows arising from the operating, investing and financing activities of each reportable segment (see Ind AS 108, *Operating Segments)*. This will provide the idea about the company as a whole as well as the various parts of the company and their efficiencies.

Illustration 10

Following is the balance sheet of Kuber Limited for the year ended March 31, 20X2

(₹ in lacs)

	20X2	*20X1*
ASSETS		
Non-current Assets		
Property, plant and equipment	*13,000*	*12,500*

Intangible assets	50	30
Other financial assets	145	170
Deferred Tax Asset (net)	855	750
Other non-current assets	800	770
Total Non-current assets	14,850	14,220
Current Assets		
Financial assets		
Investments	2,300	2,500
Cash and cash equivalents	220	460
Other current assets	195	85
Total Current assets	2,715	3,045
Total Assets	17,565	17,265
EQUITY AND LIABILITIES		
Equity		
Equity share capital	300	300
Other equity	12,000	8,000
Total equity	12,300	8,300
Liabilities		
Non-current liabilities		
Long-term borrowings	2,000	5,000
Other non-current liabilities	2,740	3,615
Total non-current liabilities	4,740	8,615
Current liabilities		
Financial liabilities		
Trade payables	150	90
Bank Overdraft	75	60
Other current liabilities	300	200
Total current liabilities	525	350
Total liabilities	5,265	8,965
Total Equity and Liabilities	17,565	17,265

Additional Information:

(1) Profit after tax for the year ended March 31, 20X2 - ₹ 4,450 lacs

(2) Interim Dividend paid during the year - ₹ 450 lacs

(3) Depreciation and amortisation charged in the statement of profit and loss during the current year are as under

(a) Property, Plant and Equipment - ₹ 500 lacs

(b) Intangible Assets - ₹ 20 lacs

(4) During the year ended March 31, 20X2 two machineries were sold for ₹ 70 lacs. The carrying amount of these machineries as on March 31, 20X2 is ₹ 60 lacs.

(5) Income taxes paid during the year ₹ 105 lacs

(6) Other non-current/current assets and liabilities are related to operations of Kuber Ltd. and do not contain any element of financing and investing activities.

Using the above information of Kuber Limited, construct a statement of cash flows under indirect method.

Solution

Statement of Cash Flows

		₹ in lacs
Cash flows from Operating Activities		
Net Profit after Tax	4,450	
Add: Tax Paid	105	
	4,555	
Add: Depreciation& Amortisation (500 + 20)	520	
Less: Gain on Sale of Machine (70-60)	(10)	
Less: Increase in Deferred Tax Asset (855-750)	(105)	
	4,960	
Change in operating assets and liabilities		
Add: Decrease in financial asset (170 - 145)	25	
Less: Increase in other non-current asset (800 - 770)	(30)	
Less: Increase in other current asset (195 - 85)	(110)	
Less: Decrease in other non-current liabilities (3,615 – 2,740)	(875)	
Add: Increase in other current liabilities (300 - 200)	100	
Add: Increase in trade payables (150-90)	60	
	4,130	
Less: Income Tax	(105)	
Cash generated from Operating Activities		**4,025**

Cash flows from Investing Activities		
Sale of Machinery	70	
Purchase of Machinery [13,000-(12,500 – 500-60)]	(1,060)	
Purchase of Intangible Asset [50-(30-20)]	(40)	
Sale of Financial asset - Investment (2,500 – 2,300)	200	
Cash outflow from Investing Activities		**(830)**
Cash flows from Financing Activities		
Dividend Paid	(450)	
Long term borrowings paid (5,000 – 2,000)	(3,000)	
Cash outflow from Financing Activities		**(3,450)**
Net Cash outflow from all the activities		**(255)**
Opening cash and cash equivalents (460 – 60)		**400**
Closing cash and cash equivalents (220 – 75)		**145**

3.20 SIGNIFICANT DIFFERENCES IN IND AS 7 VIS-À-VIS AS 3

S. No.	Particulars	Ind AS 7	AS 3
1.	*Bank Overdraft Repayable on Demand*	Ind AS 7 specifically includes bank overdrafts which are repayable on demand as a part of cash and cash equivalents	AS 3 is silent on this aspect.
2.	*Treatment of Cash Payments in Specific Cases*	Ind AS 7 provides the treatment of cash payments to manufacture or acquire assets held for rental to others and subsequently held for sale in the ordinary course of business as cash flows from operating activities. Further, treatment of cash receipts from rent and subsequent sale of such assets as cash flow from operating activity is also provided.	AS 3 does not contain such requirements.

3.	*New Examples of Cash Flows arising from Financing Activities*	Ind AS 7 includes the following new examples of cash flows arising from financing activities: (a) cash payments to owners to acquire or redeem the entity's shares (b) cash proceeds from mortgages (c) cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease.	AS 3 does not contain such examples.
4.	*Adjustment of the Profit or Loss for the Effects of Undistributed Profits of Associates and Non-controlling Interests*	Ind AS 7 specifically requires adjustment of the profit or loss for the effects of 'undistributed profits of associates and non-controlling interests' while determining the net cash flow from operating activities using the indirect method.	AS 3 does not contain such requirements.
5.	*Cash Flows associated with Extraordinary Activities*	Ind AS 7 does not contain this requirement.	AS 3 requires cash flows associated with extraordinary activities to be separately classified as arising from operating, investing and financing activities
6.	*Disclosure of the Amount of Cash and Cash Equivalents in Specific Situations*	Ind AS 7 requires an entity (except an investment entity) to disclose the amount of cash and cash equivalents and other assets and liabilities in the subsidiaries or other businesses over which control is obtained or lost. It also requires to report the aggregate amount of the cash paid or received as consideration for obtaining or losing control of	AS 3 does not contain such requirements.

		subsidiaries or other businesses in the statement of cash flows, net of cash and cash equivalents acquired or disposed of as a part of such transactions, events or changes in circumstances.	
7.	*Cash Flows arising from Changes in Ownership Interests in a Subsidiary*	Ind AS 7 requires to classify cash flows arising from changes in ownership interests in a subsidiary that do not result in a loss of control as cash flows from financing activities.	AS 3 does not contain such a requirement.
8.	*Investment in Subsidiaries, Associates and Joint Ventures (Investees)*	Ind AS 7 mentions the use of equity or cost method while accounting for an investment in an associate, joint venture or a subsidiary. It also specifically deals with the reporting of interest in an associate or a joint venture using equity method.	AS 3 does not contain such requirements.
9.	*Use of Different Terminology and Translation of Cash Flows of a Foreign Subsidiary*	Ind AS 7 uses the term 'functional currency' instead of 'reporting currency' (as used in AS 3). It also deals with translation of cash flows of a foreign subsidiary.	AS 3 does not dealt with these.
10.	*Disclosures*	Ind AS 7 requires more disclosures.	Disclosure requirement in AS 3 are less.

TEST YOUR KNOWLEDGE

Questions

1. Use the following data of ABC Ltd. to construct a statement of cash flows using the direct and indirect methods:

(Amount in ₹)

	20X2	20X1
Cash	4,000	14,000
Accounts Receivable	25,000	32,500
Prepaid Insurance	5,000	7,000
Inventory	37,000	34,000
Fixed Assets	3,16,000	2,70,000
Accumulated Depreciation	(45,000)	(30,000)
Total Assets	3,42,000	3,27,500
Accounts Payable	18,000	16,000
Wages Payable	4,000	7,000
Debentures	1,73,000	1,60,000
Equity Shares	88,000	84,000
Retained Earnings	59,000	60,500
Total Liabilities & Equity	3,42,000	3,27,500
	20X2	
Sales	2,00,000	
Cost of Goods Sold	(1,23,000)	
Depreciation	(15,000)	
Insurance Expense	(11,000)	
Wages	(50,000)	
Net Profit	1,000	

During the financial year 20X2 company ABC Ltd. declared and paid dividends of ₹ 2,500.

During 20X2, ABC Ltd. paid ₹ 46,000 in cash to acquire new fixed assets. The accounts payable was used only for inventory. No debt was retired during 20X2.

2. From the following summary cash account of XYZ Ltd, prepare cash flow statement for the year ended March 31, 20X1 in accordance with Ind AS 7 using direct method.

Summary of Bank Account for the year ended March 31, 20X1

	₹ '000		₹ '000
Balance on 1.4.20X0	50	Payment to creditors	2,000
Issue of Equity Shares	300	Purchase of Fixed Assets	200
Receipts from customers	2,800	Overhead Expenses	200
Sale of Fixed Assets	100	Payroll	100
		Tax Payment	250
		Dividend	50
		Repayment of Bank loan	300
		Balance on 31.3.20X1	150
	3,250		3,250

3. Z Ltd. has no foreign currency cash flow for the year 2017. It holds some deposit in a bank in the USA. The balances as on 31.12.2017 and 31.12.2018 were US $ 100,000 and US $ 102,000 respectively. The exchange rate on December 31, 2017 was US $ 1 = ₹ 45. The same on 31.12.2018 was US $ 1 = ₹ 50. The increase in the balance was on account of interest credited on 31.12.2018. Thus, the deposit was reported at ₹ 45,00,000 in the balance sheet as on December 31, 2017. It was reported at ₹ 51,00,000 in the balance sheet as on 31.12.2018. How these transactions should be presented in cash flow for the year ended 31.12.2018 as per Ind AS 7?

Answers

1. A. DIRECT METHOD

Cash flows from operating activities		**20X2**
Cash received from customers	2,07,500	
Cash paid for inventory	(1,24,000)	
Cash paid for insurance	(9,000)	
Cash paid for wages	(53,000)	
Net cash flow from operating activities		21,500
Cash flows from investing activities		
Purchase of fixed assets		(46,000)

Cash flows from financing activities		
Dividend paid	(2,500)	
Proceeds from issuance of debentures	13,000	
Proceeds from issue of equity	4,000	
Net cash flows from financing activities		14,500
Net decrease in cash and cash equivalents		**(10,000)**
Opening Cash Balance		**14,000**
Closing Cash Balance		**4,000**

B. INDIRECT METHOD

Cash flows from operating activities		**20X2**
Net Profit	1,000	
Adjustments for Depreciation	15,000	
	16,000	
Decrease in accounts receivable	7,500	
Decrease in prepaid insurance	2,000	
Increase in inventory	(3,000)	
Increase in accounts payable	2,000	
Decrease in wages payable	(3,000)	
Net cash flow from operating activities		21,500
Cash flows from investing activities		
Purchase of fixed assets		(46,000)
Cash flows from financing activities		
Dividend paid	(2,500)	
Proceeds from issue of debentures	13,000	
Proceeds from issue of equity	4,000	
Net cash flows from financing activities		14,500
Net decrease in cash and cash equivalents		**(10,000)**
Opening Cash Balance		**14,000**
Closing Cash Balance		**4,000**

Working notes:

Fixed Assets Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	2,70,000	By Balance c/d	3,16,000
To Cash (Purchase of Fixed Assets)	46,000		
	3,16,000		3,16,000

Inventory Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	34,000	By Cost of goods sold	1,23,000
To Creditors account (credit purchase)	2,000	By Balance c/d	37,000
To Purchase (Bal. Figure)	1,24,000		
	1,60,000		**1,60,000**

Accounts Payable Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance c/d	18,000	By Balance b/d	16,000
		By Inventory Account (credit purchase) (Bal.Fig.)	2,000
	18,000		**18,000**

Equity Share Capital Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Bal. c/d	88,000	By Balance b/d	84,000
		By Bank account (Proceeds from equity share issued)	4,000
	88,000		**88,000**

2. **XYZ Ltd.**

Cash Flow Statement for the year ended March 31, 20X1 (Using the Direct Method)

Cash flows from operating activities	₹ '000	₹ '000
Cash receipts from customers	2,800	
Cash payments to suppliers	(2,000)	
Cash paid to employees	(100)	
Cash payments for overheads	(200)	
Cash generated from operations	500	
Income tax paid	(250)	
Net cash from operating activities		250
Cash flow from investing activities		
Payments for purchase of fixed assets	(200)	
Proceeds from sale of fixed assets	100	
Net cash used in investing activities		(100)
Cash flows from financing activities		
Proceeds from issuance of equity shares	300	
Bank loan repaid	(300)	
Dividend paid	(50)	
Net cash used in financing activities		*(50)*
Net increase in cash		**100**
Cash at the beginning of the period		**50**
Cash at end of the period		**150**

3. The profit and loss account was credited by ₹ 1,00,000 (US$ 2000 × ₹ 50) towards interest income. It was credited by the exchange difference of US$ 100,000 × (₹ 50 - ₹45) that is, ₹ 500,000. In preparing the cash flow statement, ₹ 500,000, the exchange difference, should be deducted from the 'net profit before taxes, and extraordinary item'. However, in order to reconcile the opening balance of the cash and cash equivalents with its closing balance, the exchange difference ₹ 500,000, should be added to the opening balance in note to cash flow statement.

Cash flows arising from transactions in a foreign currency shall be recorded in Z Ltd.'s functional currency by applying to the foreign currency amount the exchange rate between the functional currency and the foreign currency at the date of the cash flow.

CHAPTER 5

OTHER INDIAN ACCONTING STANDARDS

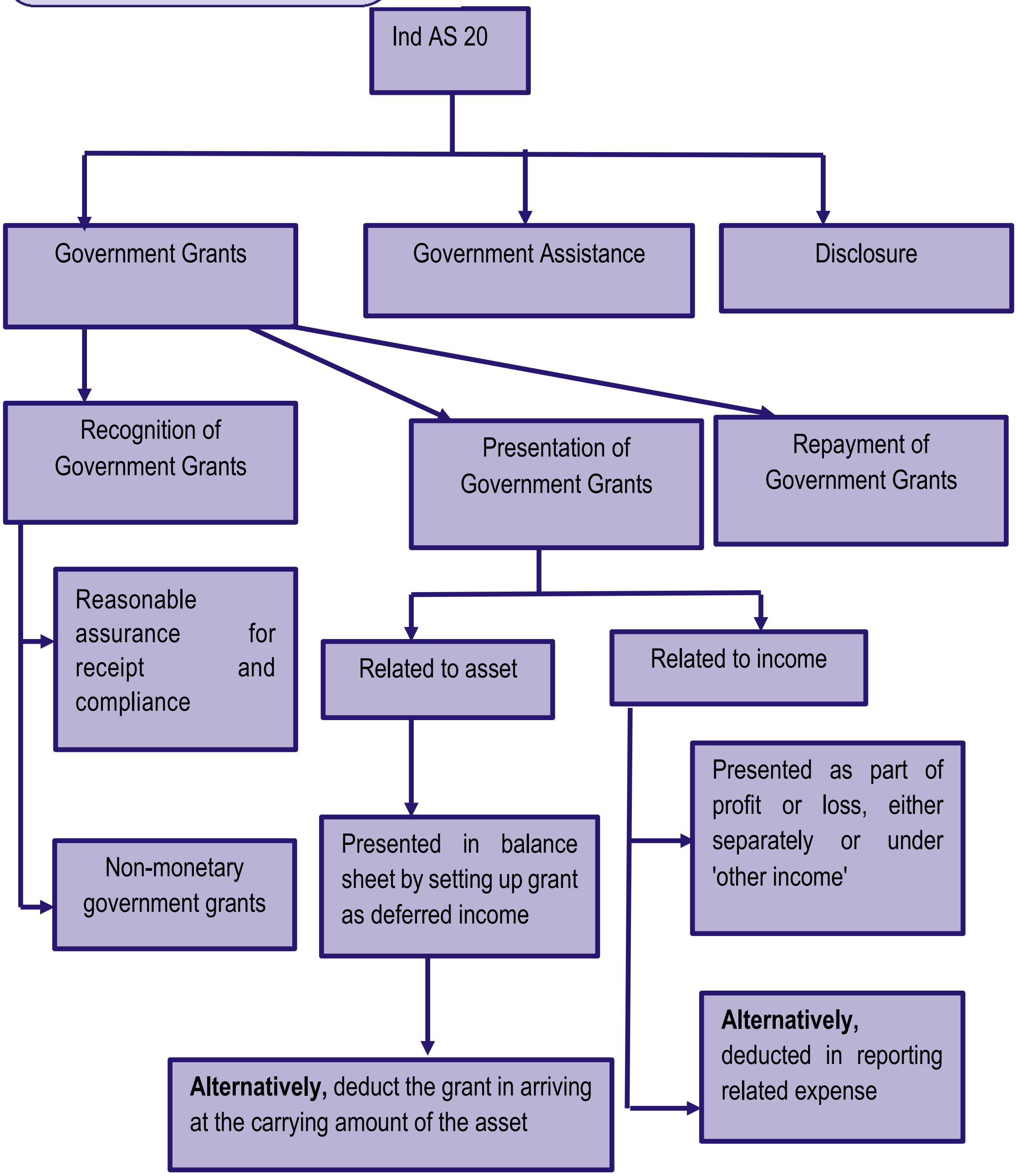
UNIT 1 : INDIAN ACCOUNTING STANDARD 20: ACCOUNTING FOR GOVERNMENT GRANTS AND DISCLOSURE OF GOVERNMENT ASSISTANCE

LEARNING OUTCOMES

After studying this unit, you will be able to understand:

- Principles for recognition of government grant including non-monetary grants
- Presentation requirements of grants related to assets and income
- Accounting for repayment of government grants

UNIT OVERVIEW



1.1 INTRODUCTION

The government gives grants to entities for various purposes including for industrial, geographic and social development, to facilitate the flow of foreign investments, to promote entrepreneurship, as subsidies to reduce the prices of goods and services offered by these entities.

The grant could be in different forms, e.g., monetary or non-monetary government grants.

Government grants may be significant for an entity and requires appropriate treatment in the books of accounts and disclosures in financial statements to facilitate comparison with other entities and with prior periods. Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance,* provides guidance on this.

1.2 SCOPE

1.2.1 Applicability

Ind AS 20 should be applied for:

(a) accounting and disclosure of government grants; and

(b) disclosure of other forms of government assistance.

1.2.2 Non-applicability

Ind AS 20 does not deal with:

(a) the special problems arising in accounting for government grants in financial statements reflecting the effects of changing prices or in supplementary information of a similar nature;

(b) government assistance that is provided for an entity in the form of benefits that are available in determining taxable profit or tax loss, or are determined or limited on the basis of income tax liability;

> **Examples** of such benefits are income tax holidays, investment tax credits, accelerated depreciation.

(c) government participation in the ownership of the entity;

(d) government grants that will be covered by Ind AS 41, *Agriculture*.

1.3. DEFINITIONS

The following definitions are relevant for the purpose of understanding of Ind AS 20:

1. ***Government*** refers to government, government agencies and similar bodies whether local, national or international.

2. ***Government assistance*** is action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria.

   Government assistance for the purpose of Ind AS 20 does not include benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints on competitors.

   Government assistance does not include the provision of infrastructure by improvement to the general transport and communication network and the supply of improved facilities such as irrigation or water reticulation which is available on an ongoing indeterminate basis for the benefit of an entire local community.

   Government assistance takes many forms varying both in the nature of the assistance given and in the conditions which are usually attached to it. The purpose of the assistance may be to encourage an entity to embark on a course of action which it would not normally have taken if the assistance was not provided.

   The receipt of government assistance by an entity may be significant for the preparation of the financial statements for two reasons:

   - Firstly, if resources have been transferred, an appropriate method of accounting for the transfer must be found.
   - Secondly, it is desirable to give an indication of the extent to which the entity has benefited from such assistance during the reporting period. This facilitates comparison of an entity's financial statements with those of prior periods and with those of other entities.

Example

Free technical assistance or marketing advice and the provision of guarantees are forms of government assistance to which no value could reasonably be assigned.

Example

An example of transactions with government which cannot be distinguished from the normal trading transactions of the entity is a government procurement policy that is responsible for a portion of the entity's sales. The existence of the benefit might be unquestioned but any attempt to segregate the trading activities from government assistance could well be arbitrary.

The significance of the benefit in the above examples may be such that disclosure of the nature, extent and duration of the assistance is necessary in order that the financial statements may not be misleading.

3. ***Government grants*** are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity.

   They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

   Government grants are sometimes called by other names such as subsidies, subventions, or premiums.

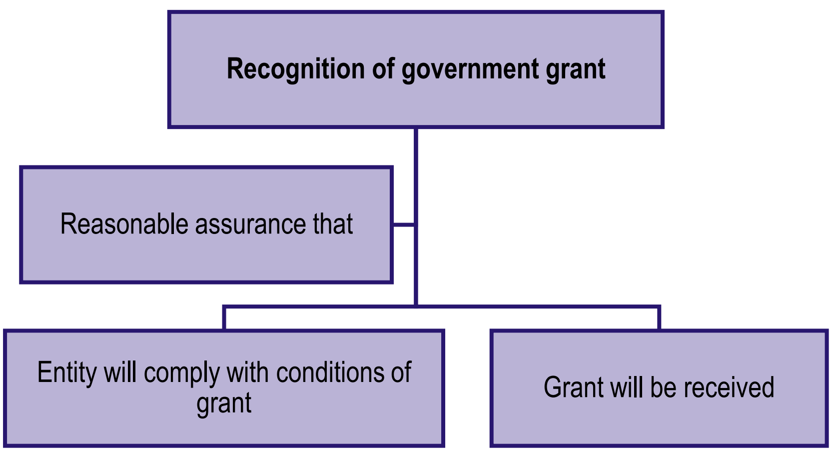
4. ***Grants related to assets*** are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

5. ***Grants related to income*** are government grants other than those related to assets.

6. ***Forgivable loans*** are loans which the lender undertakes to waive repayment of under certain prescribed conditions.

7. **Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (Ind AS 113, *Fair Value Measurement*).

1.4. RECOGNITION OF GOVERNMENT GRANTS



Government grants, including non-monetary grants at fair value, should be recognised only when there is reasonable assurance that:

(a) the entity will comply with the conditions attaching to them; and

(b) the grants will be received.

A government grant is not recognised until there is reasonable assurance that the entity will comply with the conditions attaching to it, and that the grant will be received. Receipt of a grant does not of itself provide conclusive evidence that the conditions attaching to the grant have been or will be fulfilled.

Illustration 1

Government gives a grant of ₹ 10,00,000 for research and development of H1N1 vaccine to A Pharmaceuticals Limited. There is no condition attached to the grant. Examine how the Government grant be realized.

Solution

The entire grant should be recognised immediately in profit or loss.

*****

Illustration 2

Government gives a grant of ₹ 10,00,000 for research and development of H1N1 vaccine to A Pharmaceuticals Limited even though similar vaccines are available in the market but are expensive. The entity has to ensure by developing a manufacturing process over a period of 2 years that the costs come down by at least 40%. Examine how the Government grant be realized.

Solution

The entire grant should be recognised immediately as deferred income and charged to profit or loss over a period of two years.

*****

Illustration 3

A village of artisans in a district got devastated because of an earthquake. A Limited was operating in that district and was providing employment to the artisans. The government gave a grant of ₹ 10,00,000 to A Limited so that 100 artisans are rehabilitated over a period of 3 years. Government releases ₹ 2,00,000. Examine how the Government grant be realized.

Solution

A Limited will recognise ₹ 10,00,000 as government grant and set it up as a deferred income and will recognise it in its profit or loss over the period of three years as per the principles enunciated in Ind AS 20.

Once a government grant is recognised, any related contingent liability or contingent asset is treated in accordance with Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets.*

The manner in which a grant is received does not affect the accounting method to be adopted in regard to the grant. Thus a grant is accounted for in the same manner whether it is received in cash or as a reduction of a liability to the government or in the form of a non-monetary asset.

*****

1.4.1 Forgivable loan

A forgivable loan from government is treated as a government grant when there is reasonable assurance that the entity will meet the terms for forgiveness of the loan.

1.4.2 Loans at less than market rate of interest

The benefit of a government loan at a below-market rate of interest is treated as a government grant. The loan should be recognised and measured in accordance with Ind AS 109, *Financial Instruments*. The benefit of the below-market rate of interest should be measured as the difference between the initial carrying value of the loan determined in accordance with Ind AS 109 and the proceeds received. The benefit is accounted for in accordance with Ind AS 20. The entity should consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate.

Illustration 4

A Limited received from the government a loan of ₹ 50,00,000 @ 5% payable after 5 years in a bulleted payment. The prevailing market rate of interest is 12%. Interest is payable regularly at the end of each year. Calculate the amount of government grant and Pass necessary journal entry. Also examine how the Government grant be realized.

Solution

The fair value of the loan is calculated at ₹ 37,38,328.

Year	Opening Balance	Interest calculated @ 12%	Interest paid @ 5% on ₹ 50,00,000 + principal paid	Closing Balance
(a)	(b)	(c) = (b) x 12%	(d)	(e) =(b) + (c) – (d)
1	37,38,328	4,48,600	2,50,000	39,36,928
2	39,36,928	4,72,431	2,50,000	41,59,359
3	41,59,359	4,99,123	2,50,000	44,08,482
4	44,08,482	5,29,018	2,50,000	46,87,500
5	46,87,500	5,62,500	52,50,000	Nil

A Limited will recognise ₹ 12,61,672 (₹ 50,00,000 – ₹ 37,38,328) as the government grant and will make the following entry on receipt of loan:

Bank Account	Dr.	50,00,000	
To Deferred Income			12,61,672
To Loan Account			37,38,328

₹ 12,61,672 is to be recognised in profit or loss on a systematic basis over the periods in which A Limited recognise as expenses the related costs for which the grant is intended to compensate. (see Illustration 5 in this regard)

*****

1.5 ACCOUNTING OF GOVERNMENT GRANT

There are two approaches to the accounting of government grant: 'capital approach' or 'income approach'. Under capital approach, a grant is recognised outside profit or loss, i.e., grant is credited directly to equity whereas under the income approach grant is recognised in profit or loss over one or more periods.

The Standard prescribes only the income approach despite the following arguments in favour of capital approach:

(a) government grants are a financing device and should be dealt with as such in the balance sheet rather than be recognised in profit or loss to offset the items of expense that they finance. Since no repayment is expected, such grants should be recognised outside profit or loss.

(b) it is inappropriate to recognise government grants in profit or loss, because they are not earned but represent an incentive provided by government without related costs.

The income approach has been prescribed because of the following arguments in its favour:

(a) because government grants are receipts from a source other than shareholders, they should not be recognised directly in equity but should be recognised in profit or loss in appropriate periods.

(b) government grants are rarely gratuitous. The entity earns them through compliance with their conditions and meeting the envisaged obligations. They should therefore be recognised in profit or loss over the periods in which the entity recognises as expenses the related costs for which the grant is intended to compensate.

(c) since income and other taxes are expenses, it is logical to deal also with government grants, which are an extension of fiscal policies, in profit or loss.

Principle:

Thus, government grants should be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grant is intended to compensate.

In most cases the periods over which an entity recognises the costs or expenses related to a government grant are readily ascertainable. Thus grants in recognition of specific expenses are recognised in profit or loss in the same period as the relevant expenses. Similarly, grants related to depreciable assets are usually recognised in profit or loss over the periods and in the proportions in which depreciation expense on those assets is recognised.

Illustration 5

Continuing with the facts given in the Illustration 4, state how the grant will be recognized in the statement of profit or loss assuming:

(a) the loan is an immediate relief measure to rescue the enterprise

(b) the loan is a subsidy for staff training expenses, incurred equally, for a period of 4 years

(c) the loan is to finance a depreciable asset.

Solution

₹ 12,61,672 is to be recognised in profit or loss on a systematic basis over the periods in which A Limited recognised as expenses the related costs for which the grant is intended to compensate.

Assuming (a), the loan is an immediate relief measure to rescue the enterprise. ₹ 12,61,672 will be recognised in profit or loss immediately.

Assuming (b), the loan is a subsidy for staff training expenses, incurred equally, for a period of 4 years. ₹ 12,61,672 will be recognised in profit or loss over a period of 4 years.

Assuming (c), the loan is to finance a depreciable asset. ₹ 12,61,672 will be recognised in profit or loss on the same basis as depreciation.

*****

1.5.1 Whether receipts basis permissible

Recognition of government grants in profit or loss on a receipts basis is not in accordance with the accrual accounting assumption (Ind AS 1, *Presentation of Financial Statements*) and would be acceptable only if no basis existed for allocating a grant to periods other than the one in which it was received.

1.5.2 Grants related to non-depreciable assets

Grants related to non-depreciable assets may also require the fulfilment of certain obligations and would then be recognised in profit or loss over the periods that bear the cost of meeting the obligations.

Example

A grant of land may be conditional upon the erection of a building on the site and it may be appropriate to recognise the grant in profit or loss over the life of the building once the building is constructed and put to use.

1.5.3 Conditional Grants received as part of a package of financial or fiscal aids

In such cases, care is needed in identifying the conditions giving rise to costs and expenses which determine the periods over which the grant will be earned. It may be appropriate to allocate part of a grant on one basis and part on another.

1.5.4 Grant for expenses or losses already incurred and grant as an immediate financial support

A government grant that becomes receivable as compensation for expenses or losses already incurred or for the purpose of giving immediate financial support to the entity with no future related costs should be recognised in profit or loss of the period in which it becomes receivable.

In some circumstances, a government grant may be awarded for the purpose of giving immediate financial support to an entity rather than as an incentive to undertake specific expenditures. Such grants may be confined to a particular entity and may not be available to a whole class of beneficiaries. These circumstances may warrant recognising a grant in profit or loss of the period in which the entity qualifies to receive it, with appropriate disclosures to ensure that its effect is clearly understood.

A government grant may become receivable by an entity as compensation for expenses or losses incurred in a previous period. Such a grant is recognised in profit or loss of the period in which it becomes receivable, with disclosure to ensure that its effect is clearly understood.

1.5.5 Non-monetary government grants

A government grant may take the form of a transfer of a non-monetary asset, such as land or other resources, for the use of the entity. In these circumstances the fair value of the non-monetary asset is assessed and both grant and asset are accounted for at that fair value. Alternatively, an entity may measure these grants at nominal value.

Illustration 6

A Limited wants to establish a manufacturing unit in a backward area and requires 5 acres of land. The government provides the land on a leasehold basis at a nominal value of ₹ 10,000 per acre. The fair value of the land is ₹ 100,000 per acre. Calculate the amount of the Government grant to be recognized by an entity.

Solution

A limited will recognise the land at fair value of ₹ 5,00,000 and ₹ 450,000 [(₹ 100,000 – ₹ 10,000) x 5)] as government grant. This government grant should be presented in the balance sheet by setting up the grant as deferred income.

Alternatively, the land may be recognised by A Ltd. at nominal value of ₹ 50,000 (₹ 10,000 x 5).

*****

1.5.6 Government Assistance – No Specific relation to Operating Activities

In some countries government assistance to entities may be aimed at encouragement or long-term support of business activities either in certain regions or industry sectors. Conditions to receive such assistance may not be specifically related to the operating activities of the entity.

Examples of such assistance are transfers of resources by governments to entities which:

(a) operate in a particular industry;

(b) continue operating in recently privatised industries; or

(c) start or continue to run their business in underdeveloped areas.

The issue is whether such government assistance is a 'government grant' within the scope of Ind AS 20 and, therefore, should be accounted for in accordance with Ind AS 20.

In this regard, Appendix A to Ind AS 20 provides that government assistance to entities meets the definition of government grants in Ind AS 20, even if there are no conditions specifically relating to the operating activities of the entity other than the requirement to operate in certain regions or industry sectors. Such grants should therefore not be credited directly to shareholders' interests and should be recognised in profit or loss on a systematic basis.

1.6. PRESENTATION OF GRANTS RELATED TO ASSETS

1.6.1 Presentation in the Balance Sheet

Government grants related to assets should be presented in the balance sheet by setting up the grant as deferred income. The non-monetary grants at fair value should be presented in a similar manner.

Alternatively, it can be presented in the balance sheet by deducting the grant in arriving at the carrying amount of the asset.

The grant set up as deferred income is recognised in profit or loss on a systematic basis over the useful life of the asset.

Illustration 7

A Limited establishes solar panels to supply solar electricity to its manufacturing plant. The cost of solar panels is ₹ 1,00,00,000 with a useful life of 10 years. The depreciation is provided on straight line method basis. The government gives ₹ 50,00,000 as a subsidy. Examine how the Government grant be realized.

Solution

A Limited will set up ₹ 50,00,000 as deferred income and will credit ₹ 5,00,000 equally to its statement of profit and loss over next 10 years.

Alternatively, A Ltd. may deduct ₹ 50,00,000 from the cost of solar panel of ₹ 1,00,00,000.

*****

1.6.2 Disclosure in the statement of cash flows

The purchase of assets and the receipt of related grants can cause major movements in the cash flow of an entity. For this reason and in order to show the gross investment in assets, such movements are disclosed as separate items in the statement of cash flows.

Illustration 8

Continuing with the facts given in the Illustration 7 above, state how the same will be disclosed in the Statement of cash flows.

Solution

A Limited will show ₹ 1,00,00,000 being acquisition of solar panels as outflow in investing activities. The receipt of ₹ 50,00,000 from government will be shown as inflow under financing activities.

*****

1.7 PRESENTATION OF GRANTS RELATED TO INCOME

Two methods are prescribed for presentation of grants related to income. The grant could be

(a) (first method) presented as a credit in the statement of profit and loss, either separately or under a general heading such as 'Other income'; or

(b) (second method) deducted in reporting the related expense.

The first method lays it foundation on the base:

(a) that it is inappropriate to net income and expense items and

(b) that separation of the grant from the expense facilitates comparison with other expenses not affected by a grant.

It is argued for the second method:

(a) that the expenses might well not have been incurred by the entity if the grant had not been available; and

(b) thus, presentation of the expense without offsetting the grant may therefore be misleading.

Both methods are regarded as acceptable for the presentation of grants related to income. Disclosure of the grant may be necessary for a proper understanding of the financial statements. Disclosure of the effect of the grants on any item of income or expense which is required to be separately disclosed is usually appropriate.

- Presentation of government grant
  - Related to assets
    - **Either** presented in balance sheet by setting up grant as deferred income
    - **Or** deducted from the cost of the asset
  - Related to income
    - Presented as part of profit or loss, either separately or under 'other income'
    - Alternatively, deducted in reporting related expense

1.8. REPAYMENT OF GOVERNMENT GRANTS

An entity may have to repay the government grant including in cases where conditions related to the grant are not fulfilled by it.

A government grant that becomes repayable should be accounted for as a change in accounting estimate and be treated in accordance with Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors.*

The following steps should be followed in repayment of a grant related to income:

(a) The repayment should be applied first against any unamortised deferred credit recognised in respect of the grant.

(b) To the extent that the repayment exceeds any such deferred credit, or when no deferred credit exists, the repayment should be recognised immediately in profit or loss.

The repayment of a grant related to an asset should be recognised either by reducing the deferred income balance by the amount repayable or by increasing the carrying amount of the asset.

Repayment of government grant

Related to income	Related to asset	
First applied towards any unapplied deferred credit and then charged to profit and loss account immediately	Either recognised by increasing the carrying amount of the asset	Or recognised by reducing the deferred income balance by the amount payable

1.9. DISCLOSURE

The following should be disclosed:

(a) the accounting policy adopted for government grants;

(b) the methods of presentation adopted for government grants in the financial statements;

(c) the nature and extent of government grants recognised in the financial statements;

(d) an indication of other forms of government assistance from which the entity has directly benefited. At times, the significance of the benefit of government assistance may be such that disclosure of the nature, extent and duration of the assistance is necessary in order that the financial statements may not be misleading; and

(e) unfulfilled conditions and other contingencies attaching to government assistance that has been recognised.

1.10 SIGNIFICANT DIFFERENCES BETWEEN IND AS 20 AND AS 12

S. No.	Particulars	Ind AS 20	AS 12
1.	Monetary grants related to non-depreciable assets	Taken to profit and loss account assuming that all grants have conditions attached to it. Specifically prohibits recognition of grants directly in the shareholders' funds	Credited as capital reserve. If such grant requires fulfilment of certain obligations, credit the grant amount to income over the same period over which the cost of meeting such obligations is charged to income. AS 12 also gives an alternative to treat such grants as a deduction from the cost of such asset
2.	Non-monetary government grant given at a concessional rate	Accounted for at fair value or at nominal value	• Accounted for on the basis of their acquisition cost • Non-monetary assets given free of cost are recorded at a nominal value
3.	Grants in the nature of promoter's contribution	Silent on this category (and, by implication, requiring recognition as income)	To be credited to capital reserve and to be treated as shareholders' funds

4.	Loan at concessional rates of interest	Loan to be measured at fair value and recognised as per Ind AS 109 - value of concession, i.e., difference between proceeds received and valuation done to be recognised as grant	Silent on this category
5.	Government assistance not falling within the definition of government grants	Requires an indication of other forms of government assistance from which the entity has directly benefited and should be disclosed in the financial statements	Does not deal with such government assistance

QUICK RECAP

Basic principle for recognition of government grant- Government grants should be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate.

Grants related to assets

- Recognised in profit or loss over the periods matching with depreciation expense on those assets. Alternatively, deduct the value of grant from the cst of the asset and charge depreciation on the reduced value.
- Non monetary government grants recognised at fair value. Alternatively, an entity may measure these grants at nominal value.

Grants related to income

- Recognised in profit or loss in which the specific expenses are incurred
- Grants relating to past expenses or losses or for giving immediate financial support with no further cost should be recognised in profit and loss in the period in which it becomes receivable

TEST YOUR KNOWLEDGE

Questions

1. ABC Ltd. has received the following grants from the Government of Delhi for its newly started pharmaceutical business:

   - ₹ 20 lakhs received for immediate start-up of business without any condition.
   - ₹ 50 lakhs received for research and development of drugs required for the treatment of cardiovascular diseases with following conditions:
     - that drugs should be available to the public at 20% cheaper from current market price; and
     - the drugs should be in accordance with quality prescribed by the World Health Organisation [WHO].
   - Two acres of land (fair Value: ₹ 10 Lakhs) received for set up plant.
   - ₹ 2 lakhs received for purchase of machinery of ₹ 10 lakhs. Useful life of machinery is 5 years. Depreciation on this machinery is to be charged on straight-line basis.

   How should ABC Ltd. recognise the government grants in its books of accounts?

2. A Limited received from the government a loan of ₹1,00,00,000 @ 5% payable after 5 years in a bulleted payment. The prevailing market rate of interest is 12%. Interest is payable regularly at the end of each year. Calculate the amount of government grant and Pass necessary journal entry. Also examine how the Government grant be realized. Also state how the grant will be recognized in the statement of profit or loss assuming that the loan is to finance a depreciable asset.

3. MNC Ltd. has received grant in the nature of exemption of custom duty on capital goods with certain conditions related to export of goods under Export Promotion Capital Goods (EPCG) scheme of Government of India. Whether the same is a government grant under Ind AS 20, Government Grants and Disclosure of Government Assistance? If yes, then how the same is to be accounted for if it is

   (a) A Grant related to asset or

   (b) A Grant related to income?

Answers

1. ABC Ltd. should recognise the grants in the following manner:

   - ₹ 20 lakhs have been received for immediate start-up of business. This should be recognised in Statement of Profit and Loss immediately as there are no conditions attached to the grant.
   - ₹ 50 lakhs should be recognised in profit or loss on a systematic basis over the periods which the entity recognises as expense the related costs for which the grants are

intended to compensate provided that there is reasonable assurance that ABC Ltd. will comply with the conditions attached to the grant.

- Land should be recognised at fair value of ₹ 10 lakhs and government grants should be presented in the balance sheet by setting up the grant as deferred income. Alternatively, deduct the amount of grant from the cost of the asset. In the given case, the land is granted at no cost. It will be presented in the books at nominal value.

- ₹ 2 lakhs should be recognised as deferred income and will be transferred to profit and loss over the useful life of the asset. In this cases, ₹ 40,000 [₹ 2 lakhs/5] should be credited to profit and loss each year over period of 5 years. Alternatively, ₹ 2,00,000 will be deducted from the cost of the asset and depreciation will be charged at ₹ 8,00,000 (₹ 10,00,000 – ₹ 2,00,000).

2. The fair value of the loan is calculated at ₹ 74,76,656.

Year	Opening Balance	Interest calculated @ 12%	Interest paid @ 5% on ₹ 1,00,00,000 + principal paid	Closing Balance
(a)	(b)	(c) = (b) x 12%	(d)	(e) =(b) + (c) – (d)
1	74,76,656	8,97,200	5,00,000	78,73,856
2	78,73,856	9,44,862	5,00,000	83,18,718
3	83,18,718	9,98,246	5,00,000	88,16,964
4	88,16,964	10,58,036	5,00,000	93,75,000
5	93,75,000	11,25,000	1,05,00,000	Nil

A Limited will recognise ₹ 25,23,344 (₹ 1,00,00,000 – ₹ 74,76,656) as the government grant and will make the following entry on receipt of loan:

Bank Account	Dr.	1,00,00,000	
To Deferred Income			25,23,344
To Loan Account			74,76,656

₹ 25,23,344 is to be recognised in profit or loss on a systematic basis over the periods in which A Limited recognised as expenses the related costs for which the grant is intended to compensate.

If the loan is to finance a depreciable asset. ₹ 25,23,344 will be recognised in profit or loss on the same basis as depreciation.

3. Paragraph 3 of Ind AS 20 states that Government grants are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

In accordance with the above, in the given case exemption of custom duty under EPCG scheme is a government grant and should be accounted for as per the provisions of Ind AS 20.

Ind AS 20 defines grant related to assets and grants related to income as follows:

"Grants related to asset are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held. Grants related to income are government grants other than those related to assets."

Presentation of grants related to assets

Government grants related to assets, including non-monetary grants at fair value, shall be presented in the balance sheet by setting up the grant as deferred income.

The grant set up as deferred income is recognised in profit or loss on a systematic basis over the useful life of the asset. Alternatively, the amount of grant will be deducted from the cost of the asset and depreciation will be charged on the reduced value of the asset.

Presentation of grants related to income

Grants related to income are presented as part of profit or loss, either separately or under a general heading such as 'Other income'; alternatively, they are deducted in reporting the related expense.

Presentation

In the given case, based on the terms and conditions of the scheme, the grant received is to compensate the import cost of assets subject to an export obligation as prescribed in the EPCG Scheme and does not relate to purchase, construction or acquisition of a long term asset. Hence it is a grant related to income.

Accounting of such grant

It may be further noted that as per paragraph 12 of Ind AS 20, government grants shall be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate

Grants related to income are presented as part of profit or loss, over a period of six years, either separately or under a general heading such as 'Other income'. Alternatively, they are deducted in reporting the related expense.

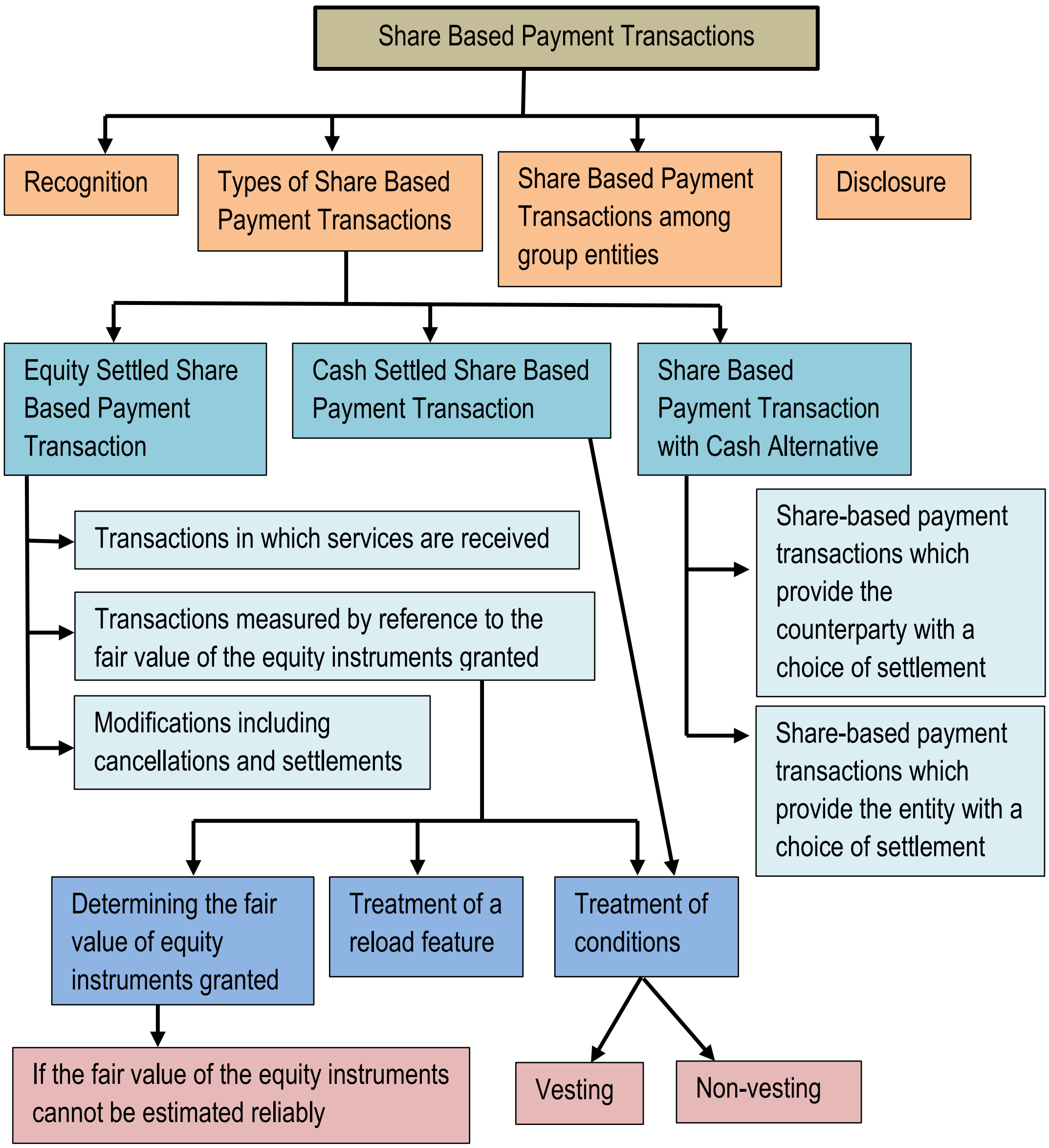
UNIT 2 : INDIAN ACCOUNTING STANDARD 102 : SHARE BASED PAYMENT

LEARNING OUTCOMES

After studying this unit, you would be able to:

- Examine the transactions as share based payment transactions
- Study the various types of share based payments
- Recognize and measure the share based payment transactions in the books
- Deal with the accounting issues in case of various vesting conditions attached with the share based payment transactions
- Calculate the fair value of share based payment transactions
- Identify the accounting treatment for Modification, cancellation and settlements of such transactions
- Make necessary and significant disclosures with respect to share based payment transactions in the financial statements.

UNIT OVERVIEW



2.1 INTRODUCTION

As the name suggests, it is a payment based on price or value of shares. Entities often grant shares or share options to employees or other parties. Share plans and share option plans are a common feature of employee remuneration, for directors, senior executives and many other employees. Some entities issue shares or share options to pay suppliers, such as suppliers of professional services.

In India, accounting of share based payment transactions is done in accordance with SEBI guidelines and Guidance Note on Accounting for Employee Share Based Payments or on the basis of Ind AS 102 "Share Based Payment". The corporate entities following Ind AS would not account for share based payment based on Guidance Note. The Companies Act, 2013 also discusses about it under section 62.

Under Section 62 (1) (b) of the Companies Act 2013, where at any time a company having a share capital proposes to increase its subscribed capital by the issue of further shares, such shares may be offered to employees under a scheme of employees' stock option, subject to a special resolution passed by the company and subject to such conditions as may be prescribed.

2.2 DEFINITION

Some of the terms used in Ind AS 102 are as follows:

a. **Cash-settled share-based payment transaction:** A share-based payment transaction in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity.

b. **Employees and others providing similar services:** Individuals who render personal services to the entity and either (a) the individuals are regarded as employees for legal or tax purposes, (b) the individuals work for the entity under its direction in the same way as individuals who are regarded as employees for legal or tax purposes, or (c) the services rendered are similar to those rendered by employees. For example, the term encompasses all management personnel, ie those persons having authority and responsibility for planning, directing and controlling the activities of the entity, including non-executive directors.

c. **Equity instrument:** A contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

d. **Equity instrument granted:** The right (conditional or unconditional) to an equity instrument of the entity conferred by the entity on another party, under a share-based payment arrangement.

e. **Equity-settled share-based payment transaction:** A share-based payment transaction in which the entity

   (a) receives goods or services as consideration for its own equity instruments (including shares or share options), or

   (b) receives goods or services but has no obligation to settle the transaction with the supplier.

f. **Fair value:** The amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction.

g. **Grant date :** The date at which the entity and another party (including an employee) agree to a share-based payment arrangement, being when the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the counterparty the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained.

h. **Intrinsic value :** The difference between the fair value of the shares to which the counterparty has the (conditional or unconditional) right to subscribe or which it has the right to receive, and the price (if any) the counterparty is (or will be) required to pay for those shares. For example, a share option with an exercise price of ₹ 15, on a share with a fair value of ₹ 20, has an intrinsic value of ₹ 5.

i. **Measurement date :** The date at which the fair value of the equity instruments granted is measured for the purposes of this Ind AS. For transactions with employees and others providing similar services, the measurement date is grant date. For transactions with parties other than employees (and those providing similar services), the measurement date is the date the entity obtains the goods or the counterparty renders service.

j. **Reload feature :** A feature that provides for an automatic grant of additional share options whenever the option holder exercises previously granted options using the entity's shares, rather than cash, to satisfy the exercise price.

k. **Reload option** : A new share option granted when a share is used to satisfy the exercise price of a previous share option.

l. **Share option :** A contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed or determinable price for a specified period of time.

m. **Vest :** To become an entitlement. Under a share-based payment arrangement, a counterparty's right to receive cash, other assets or equity instruments of the entity vests when the counterparty's entitlement is no longer conditional on the satisfaction of any vesting conditions.

n. **Vesting condition :** A condition that determine whether the entity receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement. A vesting condition is either a service condition or a performance condition.

o. **Vesting period:** The period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied.

2.2.1 Share-based payment arrangement

It is an agreement between the entity (or another group entity or any shareholder of any group entity) and another party (including an employee) that entitles the other party to receive -

(a) cash or other assets of the entity for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity, Or

(b) **equity instruments** (including shares or **share options**) of the entity or another group entity,

provided the specified **vesting conditions**, if any, are met.

2.2.2 Share Based Payment Transaction

It is a transaction in which the entity -

(a) receives goods or services from the supplier of those goods or services (including an employee) in a share-based payment arrangement, or

(b) incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another group entity receives those goods or services.

Analysis of share based payment (SBP)

1. Share based payment should be formed with an **agreement** between an entity & a party (includes employees) which essentially means that a communication of the terms and conditions should be in place in order to have share based payment.

Example

A management committee of an entity has initiated a plan to provide some stock options to its employees but there are some terms which are yet to be finalized and the plan is not yet communicated to the employee. Since, there is no formal communication stating the terms or conditions of the agreement, it will not attract Ind AS 102 provisions. The standard will be attracted when there will be a binding arrangement.

2. Share based payments should be made for goods/ services and should be with an external person e.g. supplier including employee.

Example

Goods/services have been received by an entity for which it has issued its own equity shares to the counterparty (who has supplied the goods) at discount/ premium. The value of the goods received has been paid by using its own equity shares but if the fair value of the goods received are more / less than the value of share issued by an entity, then some un-identified goods / services will be received / or have been received. Hence, Ind AS 102 will still be applicable for such unidentified goods/ services.

Example

An entity issuing its own shares for a charity without any consideration will be covered under Ind AS 102.

3. Goods/services that are being received by an entity should be from a supplier which will include an employee of the entity. The goods/services received from a counterparty who act in the capacity of shareholder will not be covered under Ind AS 102.

Example

Service Maintenance Agreement has been entered by an entity with one of the supplier, outside the entity which requires to pay for these services by issuing equity shares of the entity. Such an agreement will be covered under Ind AS 102.

4. A transaction with an employee (or other party) in his/her capacity as a holder of equity instruments of the entity is not a share-based payment transaction.

Example

An entity issued right shares to all its shareholders which include employees of the company. Since the employees who have received such shares are acting in a capacity of shareholders and not as employees, this transaction will **not** be covered under Ind AS 102.

5. For receiving goods / services, an entity needs to settle the transaction either by issuing its own equity shares / or group entity's shares (which is called as "equity settled") or by paying cash amount equivalent against such shares (which is called as "cash settled") or a combination of these two where settlement option rests either with an entity or with the counterparty.

6. Equity instruments, which means a residual interest in asset & liability of the company will include –

   a) Ordinary shares

   b) Redeemable preference shares

c) Written call option or warrants over such ordinary shares.

7. Share based payment transaction may be settled by an entity through its own equity shares or one of group's entity shares which means that a parent of the reporting entity might issue shares on behalf of its subsidiary for providing goods/services to its subsidiary and the same transaction will be covered under Ind AS 102.

Example

1. A parent issues share options to the employee of its subsidiary company or a subsidiary company issues share options to its employees based on the price of equity shares of its parent company. Both the plans will be covered under Ind AS 102.

2. An entity issues certain benefits to its employees by taking a reference of earnings of next year. Since the benefit is **not** based on share price of the entity, hence this transaction will not be covered under Ind AS 102. However, it may be treated as employee benefits under Ind AS 19.

8. Vesting conditions means the criteria which is to be fulfilled (if it is required as per the share based agreement) in order to get such Shared based payment.

Example

A stock option has been issued by an entity to its employees those who remain in service for next 4 years. Those who leave before 4 years will not get the share based payments. Staying with the organization for 4 years is a vesting condition in order to get the shared based payment.

2.3 SCOPE

2.3.1 What is covered within Ind AS 102?

Based on the analysis of the definitions, the scope of the standard are as follows:

- Covers settlement in equity or in cash or alternative settlement option i.e. to issue shares or by paying cash.
- Even if an entity is not able to identify all goods/ services that are being received by settling the transaction, either by issuing its own equity/ group's equity or by paying a cash value equivalent to the equity prices, still it will be covered under Ind AS 102.
- Un-identified goods/ services that are being received will be covered in the standard.

- Share based payment can be settled by another group entity or by using equity shares of group's entity.
- Employee of a company, working as a service provider to an entity and receiving share based payments (e.g. stock options, warrants etc.) will be covered under this standard.
- Goods will include inventories, consumables, property, plant & equipment and other non-financial items.

Example

1. An entity grants 10 shares to its employees who will remain in service for next 2 years - this will be covered within the standard as equity settled share based payment.
2. An entity grants ₹ 1,000 to each employee which is based on its current equity price. This will not be covered under Ind AS 102 as the amount of ₹ 1,000 is fixed now and it will be paid to the employees even if the market rate of its share goes up/down from the current level.
3. An entity received services from a party who is acting as shareholder will not be covered under the standard. However, an employee who received additional payment from the entity for providing services other than its normal employment will be covered under this standard.
4. An entity has agreed to provide bonus to its employees purely based on the share price of the entity. Since the benefit is with reference to the share price of the entity, hence it will be covered under Ind AS 102.

2.3.2 What is not covered in Ind AS 102?

Transactions with shareholders as a whole, i.e., when the shareholders act solely in their capacity as shareholders.

Example

If an entity grants all holders of a particular class of its equity instruments the right to acquire additional equity instruments of the entity at a price that is less than the fair value of those equity instruments, and an employee receives such a right because he/she is a holder of equity instruments of that particular class, the granting or exercise of that right is not subject to the requirements of Ind AS 102.

- Entity shall not apply this standard to transactions in which the entity acquires goods as part of net assets acquired in business combinations as defined by Ind AS 103 'Business Combinations', or contribution for Joint ventures as per Ind AS 111 'Joint Arrangements'.

Example

1. An entity has issued equity instruments in exchange for control of the acquiree is not within the scope of this standard. However, if the equity instruments are being issued to acquiree's employees in their capacity as employee, then it will be covered under Ind AS 102.

2. An entity buys a business from an individual to whom equity instruments are being issued. The individual will be working as an employee in the combined new entity. The instruments that are being issued as part of business purchase consideration under Ind AS 103 'Business Combination', then this transaction will not be covered under Ind AS 102. However, if the equity instrument is being issued in the capacity of accepting employment in new company, then it will be covered within Ind AS 102.

- Financial instruments issued to buy/sell non-financial items which can be settled at net will be outside Ind AS 102.

Example

Contracts for purchase and sale of goods/ services which are entered for settling in net amounts/ or keep it for speculation purposes will be covered under Ind AS 109- Financial Instruments and hence will not be covered under Ind AS 102.

2.4 RECOGNITION

An entity shall recognise the goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received. The entity shall recognise a corresponding increase in equity if the goods or services were received in an equity-settled share-based payment transaction, or a liability if the goods or services were acquired in a cash-settled share based payment transaction.

Analysis of recognition of SBP (Share based payments)

- All such goods / services which are being received in share based payment will be recognized when such goods are received or services are obtained.
- An entity would recognize an expense or an asset if the goods and/or services received meet the criteria for recognition as an asset.

- A corresponding increase in equity for equity settled transactions or in liabilities for cash-settled transactions would be recognized.
- The recognition will depend on vesting conditions, if any (in certain cases there will not be any vesting condition). It means if there are certain conditions either service related or performance related which needs to be completed in order to be eligible for such Share based payments, then recognition will be based on the best estimate of the expected vesting value of such share based payments.

Example

1. An entity purchases some inventory from a supplier for which the entity will issue 100 shares as payment. The fair value of the shares was ₹ 15,000. On purchase of inventory, the transaction will be recorded by a debit to the inventory and a credit to equity with an amount of ₹ 15,000 i.e. taking fair value of goods/ services so transacted (except in case of transactions with an employee). However, if the fair value of goods/ services is not reliably measurable, then fair value of shares can be considered.
2. An entity has given 100 stock options to each of its 1,000 employees for those who will remain in service for next 4 years. The grant date was 1st January, 20X1. The condition to remain in service shows that the stock option has been given for the services to be provided in the next 4 years; hence at the end of each year, the entity will estimate the expected no of employees who will remain in service and accordingly will recognize the cost over 4 years.

2.5 TYPES OF SHARE BASED PAYMENTS

2.5.1 Equity Settled- Share Based Payments

For equity-settled share-based payment transactions, the entity shall measure the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the entity cannot estimate reliably the fair value of the goods or services received, the entity shall measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted.

Analysis of the Equity Settled Share based payments

- As per Ind AS 102, all goods or services which are received by an entity should be fair valued in order to arrive at the transaction price to recognize the share based payment.
- In the absence of reliable information to arrive at the fair value of goods & services received, the fair value of equity instrument issued will be used.

- In case of EMPLOYEES, it is required by the standard to use fair value of equity granted because it is practically not possible to identify the fair value of the services rendered by the employees.
- In case of awards to non-employees, there is a rebuttable presumption that the fair value of goods/services received from any external supplier can be estimated. However, if this is not feasible, then an indirect reference can be used by taking fair value of instruments issued.
- There might be some cases where the transaction is other than with employee, where goods / services received are less than the fair value of equity share issued then some un-identified goods / services are recognized by taking a difference between fair value of equity instruments issued and fair value of goods / services received.

Example

1. An entity has agreed to issue 100 shares to each of its 500 employees if they remain in service for next 3 years. In this case 3 years is a service period for which shares will be issued the entity, however, since this is share based payment plan with employees of the entity, hence the fair value of equity instruments issued will be used for calculating transaction value of the share based payments.
2. An entity agreed to issue 100 shares to a supplier for providing some consultancy services for next 2 years. There is similar contract in the market which has a value of ₹ 20,000. The similar value of the contract will be used as fair value of this share based payment transaction unless there is no reliable fair value is available.

Illustration 1 - Equity Settled Shared Based Payment- Service conditions

ABC Limited granted to its employees, share options with a fair value of ₹ 5,00,000 on 1st April, 20X0, if they remain in the organization upto 31st March, 20X3. On 31st March, 20X1, ABC limited expects only 91% of the employees to remain in the employment. On 31st March, 20X2, company expects only 89% of the employees to remain in the employment. However, only 82% of the employees remained in the organisation at the end of March, 20X3 and all of them exercised their options. Pass the Journal entries?

Solution

Period	Proportion a	Fair value b	To be vested c	Cumulative expenses d= b x c x a	Expenses e = d-previous period d
Period 1	1/3	5,00,000	91%	1,51,667	1,51,667
Period 2	2/3	5,00,000	89%	2,96,667	1,45,000
Period 3	3/3	5,00,000	82%	4,10,000	1,13,333
					4,10,000

Journal Entries

31st March, 20X1			
Employee benefits expenses	Dr.	1,51,667	
To Share based payment reserve (equity)			1,51,667
(1/3 of expected vested equity instruments value)			
31st March, 20X2			
Employee benefits expenses	Dr.	1,45,000	
To Share based payment reserve (equity)			1,45,000
(2/3 of expected vested equity instruments value)			
31st March, 20X3			
Employee benefits expenses	Dr.	1,13,333	
To Share based payment reserve (equity)			1,13,333
(Final vested equity instruments value)			
Share based payment reserve (equity)	Dr.	4,10,000	
To Share Capital			4,10,000
(re-allocated and issued shares)			

*****

2.5.2 Cash Settled- Share Based Payments

For cash-settled share-based payment transactions, the entity shall measure the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the entity shall remeasure the fair value of the liability at the end of each reporting period and at the date of settlement, with any changes in fair value recognized in profit or loss for the period.

Analysis of the Cash Settled Share Based Payments

- It is a plan where entity issues rights to its employees/ suppliers where employees/ suppliers will be entitled for a cash payment in future based on equity share prices of the entity / or equity prices of the Group (group means parent company of the entity). In some cases right to increase in equity prices is also provided which is known as Share Appreciation Rights (SAR).
- The goods/ services received against share based payment plan to be settled in cash are measured at fair value of the liability and the liability continues to re-measured at every reporting date until it is actually paid off.

- There could be vesting conditions attached to the share based payment plans e.g. to remain in service for next 3 years etc. The recognition of such share based payment plans should be done by recognizing fair value of the liability at the time of goods/ services received and not at the date of grant. The liability so recognized will be fair valued at each reporting date and difference in fair value will be charged to profit or loss for the period.
- There could be some cases where no vesting period/ condition is required to be fulfilled, in those cases, cash settled share based payment can be recognized in full at initial recognition itself.

Examples

1. An entity issued share appreciation rights to its existing employees who remains in service for next 3 years and the benefit will then be settled in cash of an equivalent amount of share price.
2. Management of an entity decides to issue bonus amount to certain key employees for their past services based on share price of the entity. The amount equivalent to the shares will be recognized immediately as cost of employees because there are no conditions which are to be vested upon.

Illustration 2 - Cash Settled Shared Based Payment-Service conditions

XYZ issued 10,000 Share Appreciation Rights (SARs) that vest immediately to its employees on 1st April, 20X0. The SARs will be settled in cash. Using an option pricing model, at that date it is estimated that the fair value of a SAR is ₹ 95. SAR can be exercised any time upto 31st March, 20X3. At the end of period on 31st March, 20X1 it is expected that 95% of total employees will exercise the option, 92% of total employees will exercise the option at the end of next year and finally 89% will be vested only at the end of the 3rd year. Fair Values at the end of each period have been given below:

Fair value of SAR		₹
31st March, 20X1		*112*
31st March, 20X2		*109*
31st March, 20X3		*114*

Pass the Journal entries?

Solution

Period	Fair value a	To be vested b	Cumulative c= a x b x 10,000	Expense d= c-prev. period c
Start	95	100%	9,50,000	9,50,000
Period 1	112	95%	10,64,000	1,14,000

Period 2	109	92%	10,02,800	(61,200)
Period 3	114	89%	10,14,600	11,800
				10,14,600

Journal Entries

1st April, 20X0			
Employee benefits expenses To Share based payment liability (Fair value of the SAR recognized)	Dr.	9,50,000	9,50,000
31st March, 20X1			
Employee benefits expenses To Share based payment liability (Fair value of the SAR re-measured)	Dr.	1,14,000	1,14,000
31st March, 20X2			
Share based payment liability To Employee benefits expenses (Fair value of the SAR re-measured & reversed)	Dr.	61,200	61,200
31st March,-20X3			
Employee benefits expenses To Share based payment liability (Fair value of the SAR recognized)	Dr.	11,800	11,800
Share based payment liability To Cash (Settlement of SAR)	Dr.	10,14,600	10,14,600

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2.5.3 Share Based Payment Transactions with Cash Alternatives

For share-based payment transactions in which the terms of the arrangement provide either the entity or the counterparty with the choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments, the entity shall account for that transaction, or the components of that transaction, as a cash settled share-based payment transaction if, and to the extent that, the entity has incurred a liability to settle in cash or other assets, or as an equity-settled share-based payment transaction if, and to the extent that, no such liability has been incurred.

Analysis of Share Based Payment Transactions with Cash Alternatives

- The choice either to settle in cash or equity may be with the entity or its counterparty which will define the way of recognizing such alternatives either equity-settled or cash-settled. The choice to select the cash or equity alternatives can be segregated in two parts –

  a) When Counterparty has a choice of settlement

  - When counterparty has a choice of settlement for such share based payments, then this will be treated as compound instrument which has debt and equity components.
  - When such alternatives are given in case of transactions with parties other than employees where fair value of goods/ services is measured directly then the difference between fair value of such goods/ services and the fair value of debt component, at the date when the goods or services are received, will be considered to be the value of equity component.
  - For other transactions, including transactions with employees, a separate fair value of compound financial instruments will be calculated and accordingly the values of goods/services received will be accounted. To apply this requirement, the entity shall first measure the fair value of the debt component, and then measure the fair value of the equity component— taking into account that the counterparty must forfeit the right to receive cash in order to receive the equity instrument. The fair value of the compound financial instrument is the sum of the fair values of the two components. However, share-based payment transactions in which the counterparty has the choice of settlement are often structured so that the fair value of one settlement alternative is the same as the other. For example, the counterparty might have the choice of receiving share options or cashsettled share appreciation rights. In such cases, the fair value of the equitycomponent is zero, and hence the fair value of the compound financial instrument is the same as the fair value of the debt component. Conversely, if the fair values of the settlement alternatives differ, the fair value of the equity component usually will be greater than zero, in which case the fair value of the compound financial instrument will be greater than the fair value of the debt component.
  - The entity shall account separately for the goods or services received or acquired in respect of each component of the compound financial instrument. For the debt component, the entity shall recognise the goods or services acquired, and a liability to pay for those goods or services, as the counterparty supplies goods or renders service, in accordance with the requirements applying to cash-settled share-based payment transactions. For the equity component (if any), the entity shall recognise the goods or services received, and an increase in equity, as the counterparty

supplies goods or renders service, in accordance with the requirements applying to equity-settled share-based payment transactions.

- At the date of settlement, the entity shall remeasure the liability to its fair value. If the entity issues equity instruments on settlement rather than paying cash, the liability shall be transferred direct to equity, as the consideration for the equity instruments issued.
- If the entity pays in cash on settlement rather than issuing equity instruments, that payment shall be applied to settle the liability in full. Any equity component previously recognised shall remain within equity. By electing to receive cash on settlement, the counterparty forfeited the right to receive equity instruments. However, this requirement does not preclude the entity from recognising a transfer within equity, i.e. a transfer from one component of equity to another.

Example

1. An entity issues stock options to its employees which can be claimed either in cash or equity instrument of an entity. Employees need to be in service for next 2 years. Entity needs to find fair value component of equity to be settled and fair value of cash amount to be settled. Each balance sheet date, these values need to be updated. Upon the exercising of the option, if it is in equity then fair value liability will be transferred to the equity in full.
2. An entity buys some equipment from a supplier and provides an option to the supplier to either take cash or equity instrument equivalent to the value of the share price of the entity. The entity will first find out the fair value of the goods received, then fair value of cash settlement will be valued. The difference of the fair value of the goods received and fair value of cash settlement option will be treated as fair value of equity component.

b) *When the entity has a choice of settlement*

If the entity can choose the settlement method then the whole award would be treated as either cash-settled or equity-settled, depending on-

- Whether entity has a present obligation to settle in cash in which case accounting of award would be as a liability. The assumption to consider present obligation to settle in cash would be in those cases when there is no commercial substance to issue equity (e.g. restriction to issue new share capital etc.) or there is past practice or stated policy to settle such type of arrangement in cash only or entity has generally settled in cash whenever counterparty asks for cash settlement.
- There is no such obligation to pay in cash then equity settled accounting treatment would be required.

In case, equity settled accounting has been done but the settlement is required to be done in cash then it would be accounted for as repurchase of an equity interest.

Upon settlement, if the entity elects the settlement alternative with the higher fair value, as at the date of settlement, the entity shall recognise an additional expense for the excess value given, i.e. the difference between the cash paid and the fair value of the equity instruments that would otherwise have been issued, or the difference between the fair value of the equity instruments issued and the amount of cash that would otherwise have been paid, whichever is applicable.

Example

1. An entity issues stock options to its employees which provide entity an option to settle either in cash or by entity's own shares. As per the past practice of the entity, these kind of stock options have been settled in cash only, hence the entity will create a liability assuming present obligation to settle the options in cash.
2. An entity has issued certain stock options to its employees where it has right to settle these options either in cash or by its own equity. Based on the past practices, the entity assumed the settlement will be done in equity only and accordingly the fair value of such options at grant date was credited to equity (based on expected vesting rights). However, the options were actually settled in cash, hence all such equity portion will be debited to the extent it was credited as re-purchasing the equity shares, and the portion above the equity portion so debited will be transferred to Profit and Loss of the period.

Illustration 3 – Share-based payment with cash alternative

On 1st January, 20X1, ABC limited gives options to its key management personnel (employees) to take either cash equivalent to 1,000 shares or 1,500 shares. The minimum service requirement is 2 years and shares being taken must be kept for 3 years.

Fair values of the shares are as follows:	*₹*
Share alternative fair value (with restrictions)	*102*
Grant date fair value on 1st January, 20X1	*113*
Fair value on 31st December, 20X1	*120*
Fair Value on 31st December, 20X2	*132*
The employees exercise their cash option at the end of 20X2. Pass the journal entries.	

Solution

	1st January, 20X1 ₹	31st December, 20X1 ₹	31st December, 20X2 ₹
Equity alternative (1,500 x 102)	1,53,000		
Cash alternative (1,000 x 113)	1,13,000		
Equity option (1,53,000 - 1,13,000)	40,000		
Cash Option (cumulative) (using period end fair value)		(1,000 x 120 x ½) 60,000	1,32,000
Equity Option (cumulative)		(40,000 x ½) 20,000	40,000
Expense for the period			
Equity option		20,000	20,000
Cash Option		60,000	72,000
Total		80,000	92,000

Journal Entries

31st December, 20X1		₹	
Employee benefits expenses	Dr.	80,000	
To Share based payment reserve (equity)			20,000
To Share based payment liability			60,000
(Recognition of Equity option and cash settlement option)			
31st December, 20X2			
Employee benefits expenses	Dr.	92,000	
To Share based payment reserve (equity)			20,000
To Share based payment liability			72,000
(Recognition of Equity option and cash settlement option)			
Share based payment liability	Dr.	1,32,000	
To Bank/ Cash			1,32,000
(Settlement in cash)			

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Illustration 4 –Share-based payment - Purchase of goods

Indian Inc. issued 995 shares in exchange for purchase of an office building. The title was transferred in the name of Indian Inc. on February, 20X1 and shares were issued. Fair value of the office building was ₹ 2,00,000 and face value of each share of Indian Inc was ₹ 100.

Pass the journal entries?

Solution

1st February, 20X1			₹
Office Building	Dr.	2,00,000	
To Share capital (995 x 100)			99,500
To Securities premium (balance)			1,00,500
(Recognition of equity option and cash settlement option)			

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Illustration 5 – Share-based payment - Services

Reliance limited hired a maintenance company for its oil fields. The services will be settled by issuing 1,000 shares of Reliance. Period for which the service is to be provided is 1st April, 20X1 to 1st July, 20X1 and fair value of the service was estimated using market value of similar contracts for ₹ 1,00,000. Nominal value per share is ₹ 10.

Record the transactions?

Solution

Fair value of services	1,00,000
Number of months	3
Monthly expense	33,333.33

30th April, 20X1			₹
Repair & Maintenance	Dr.	33,333.33	
To Share based payment reserve (equity)			33,333.33
(Recognition of Equity settled SBP using fair value of services rendered)			
31st May, 20X1			
Repair & Maintenance	Dr.	33,333.33	
To Share based payment reserve (equity)			33,333.33
(Recognition of Equity settled SBP using fair value of services rendered)			

30th June, 20X1			
Repair & Maintenance	Dr.	33,333.33	
To Share based payment reserve (equity)			33,333.33
(Recognition of Equity settled SBP using fair value of services rendered)			

1st July, 20X1			
Share based payment reserve (equity)	Dr.	1,00,000	
To Equity Shares (1000 x 10)			10,000
To Securities premium (balancing figure)			90,000

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Illustration 6 – Share-based payment - Cash & equity alternatives

Tata Industries issued share-based option to one of its key management personal which can be exercised either in cash or equity and it has following features:

Option I		*Period*	*₹*
No of cash settled shares			*74,000*
Service condition		*3 years*	
Option II			
No of equity settled shares			*90,000*
Conditions:			
Service		*3 years*	
Restriction to sell		*2 years*	
Fair values			
Equity price with a restriction of sale for 2 years			*115*
Fair value grant date			*135*
Fair value	*20X0*		*138*
	20X1		*140*
	20X2		*147*

Pass the Journal entries?

Solution

Fair value of Equity option components:		
Fair value of a share with restrictive clause		₹ 115
Number of shares		90,000
Fair value (90,000 x 115)	A	₹ 1,03,50,000
Fair value of a share at the date of grant		₹ 135
Number of cash settled shares		74,000
Fair value (74,000 x 135)	B	₹ 99,90,000
Fair value of equity component in compound instrument (A-B)		₹ 3,60,000

Journal Entries

31/12/20X0			₹
Employee benefit expenses	Dr.	35,24,000	
To Share based payment reserve (equity) (3,60,000/3)			1,20,000
To Share based payment liability (138 x 74,000) / 3			34,04,000
(Recognition of equity option and cash settlement option)			
31/12/20X1			
Employee benefits expenses	Dr.	36,22,667	
To Share based payment reserve (equity) (3,60,000/3)			1,20,000
To Share based payment liability (140 x 74,000) 2/3 -34,04,000			35,02,667
(Recognition of equity option and cash settlement option)			
31/12/20X2			
Employee benefits expenses	Dr.	40,91,333	
To Share based payment reserve (equity) (3,60,000/3)			1,20,000
To Share based payment liability (147 x 74,000) 3/3 - (34,04,000 + 35,02,667)			39,71,333
(Recognition of equity option and cash settlement option)			
Upon cash alternative chosen			
Share based payment liability (147 x 74,000)	Dr.	1,08,78,000	
To Bank/ Cash			1,08,78,000
(Being settlement made in cash)			

Upon equity alternative chosen		
Share based payment liability Dr.	1,08,78,000	
To Equity		1,08,78,000
(Being settlement made in equity)		

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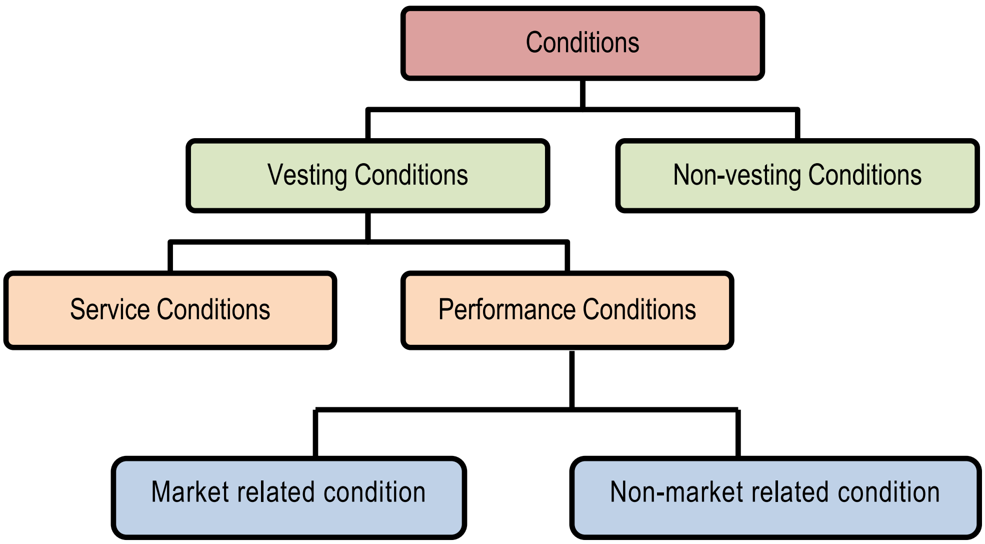
2.6 DETERMINING TYPES OF CONDITIONS



2.6.1 Vesting conditions

Share based payment awards generally vest upon meeting specified conditions, such as service conditions (time-based) or performance conditions (eg. achieving a specified EBITDA target). These conditions affect the timing of when the expense is recognized, and in some cases, the measurement of expense. In addition, if a condition is not met, whether or not the entity may reverse previously recognized compensation expense depends on the nature of the condition that was not met. Hence classification of a condition is an important step in accounting of share based payments.

Following are the classification of various conditions and their accounting requirements.

a) Service condition

When share based payment is dependent upon the minimum term to be served in order to be eligible for employees share based payment, it is called service condition.

Example

An entity has issued 100 shares each to its 1,000 employees under share based payment if they remain in the organization for next 3 years. This would be considered to be a service condition; 3 years being the period over which employee would be required to be in service as a condition.

b) Performance condition

If an employee is granted share options conditional upon the achievement of a performance condition and remaining in the entity's employment until that performance condition is satisfied, and the length of the vesting period varies depending on when that performance condition is satisfied, the entity shall presume that the services to be rendered by the employee as consideration for the share options will be received in the future, over the expected vesting period. The entity shall estimate the length of the expected vesting period at grant date, based on the most likely outcome of the performance condition.

Performance condition may be

a. market-related; or

b. non-market related.

i. Market related condition

In order to be eligible for share based payment, when one of the conditions is to achieve target price/ value of the share by an entity, it is called as market-related performance condition. If the performance condition is a market condition, the estimate of the length of the expected vesting period shall be consistent with the assumptions used in estimating the fair value of the options granted, and shall not be subsequently revised.

Example

An entity issues stock options to its employees who will serve the organization for next 2 years and till the time the share price reaches to ₹ 100. The target price to reach ₹ 100 is one of the market related condition.

ii. Non-market related condition

When the parameter is not market driven but linked with some internal performance/ operations or activities of the entity, it will be considered as non-market related conditions. Non- market related conditions do not have any impact on market price of the shares of the entity issuing such share based payments. If the performance condition is not a market condition, the entity shall revise its estimate of the length of the vesting period, if necessary, if subsequent information indicates that the length of the vesting period differs from previous estimates.

Example

An entity issued some stock options to employees with a condition that they have to remain in the organisation for next 2 years and EBITA of the entity should rise to ₹ 10 million. Here, the EBITA target is non-market related condition.

2.6.2 Non-vesting conditions

Such conditions which do not have any impact on eligibility to have share based payments. It has not been specifically defined by the standard. However, one can understand this as conditions which are other than vesting conditions.

Example

An entity issued some stock options to its employees wherein they are required to serve minimum period of next 2 years and from the end of 2nd year there will further be waiting time till next 1 year within which the entity should achieve revenue of ₹ 100 million. However, if an employee leaves the entity after the end of 2nd year then the employee will not lose its entitlement to get such share based payments. Hence the condition of achieving revenue target is non-vesting condition.

2.7 DETERMINING IMPACT OF CONDITIONS ON SHARE BASED VALUATION

Once we understood the conditions attached with any share based payment, next question arises that about the implication of the conditions on accounting/ measurement of such share-based payments and why it is crucial to segregate them.

a. A grant of equity instruments might be conditional upon satisfying specified vesting conditions. For example, a grant of shares or share options to an employee is typically conditional on the employee remaining in the entity's employment for a specified period of time. There might be performance conditions that must be satisfied, such as the entity achieving a specified growth in profit or a specified increase in the entity's share price. Vesting conditions, other than market conditions, shall not be taken into account when estimating the fair value of the shares or share options at the measurement date. Instead, vesting conditions shall be taken into account by adjusting the number of equity instruments included in the measurement of the transaction amount so that, ultimately, the amount recognised for goods or services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest. Hence, on a cumulative basis, no amount is recognised for goods or services received if the equity instruments granted do not vest because of failure to satisfy a vesting condition, eg the counterparty fails to complete a specified service period, or a performance condition is not satisfied, subject to the requirements mentioned below in point c.

b. To apply the requirements mentioned in abovementioned point (a), the entity shall recognise an amount for the goods or services received during the vesting period based on the best available estimate of the number of equity instruments expected to vest and shall revise that estimate, if necessary, if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates. On vesting date, the entity shall revise the estimate to equal the number of equity instruments that ultimately vested, subject to the requirements mentioned below in point c.

c. Market conditions, such as a target share price upon which vesting (or exercisability) is conditioned, shall be taken into account when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with market conditions, the entity shall recognize the goods or services received from a counterparty who satisfies all other vesting conditions (eg services received from an employee who remains in service for the specified period of service), irrespective of whether that market condition is satisfied.

d. Similarly, an entity shall take into account all non-vesting conditions when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with non-vesting conditions, the entity shall recognise the goods or services received from a counterparty that satisfies all vesting conditions that are not market conditions (eg services received from an employee who remains in service for the specified period of service), irrespective of whether those non-vesting conditions are satisfied.,

Treatment of a reload feature

For options with a reload feature, the reload feature shall not be taken into account when estimating the fair value of options granted at the measurement date. Instead, a reload option shall be accounted for as a new option grant, if and when a reload option is subsequently granted.

Below mentioned table summarizes the impact of various conditions –

Conditions	To include in fair value of SBP (refer note-1)	To include expected equity shares which meet conditions (refer note-2)
Service condition	No	Yes
Performance condition - Market related	Yes	No
Performance condition - Non-market related	No	Yes
Non-vesting condition	Yes	No

Note 1 Share based payment will be measured at fair value on initial recognition which will include the effect of these conditions. Equity settled share based payment will be measured at fair

value on grant date with no subsequent measurement, whereas cash settled share based payment shall be re-measured at each reporting date till its settlement in full.

Note 2 These conditions will have no impact on fair valuation of share based payments. However, they will be considered while estimating the expected number of equity shares at the end of each period for recognition of the share based payment.

Example

An entity issued 100 shares each to its 1000 employees under share based payment upon the condition to serve the organization for at least next 2-years subject to the below scenarios:

1) EBIDTA of the entity shall be ₹ 10 million in next 2 years.

2) Share price of the entity shall be ₹ 150 in next 2 years.

3) Employee is required to serve additional 4 months from the end of 2 years but will have no impact on vesting rights at the end of 2^{nd} year.

Since 2 years to remain in service is a 'service related condition', it will be considered in the calculation of expected number of shares which will satisfy the conditions attached.

1) **EBIDTA** is one of the performance conditions which is non-market related, hence will be considered while making an estimation of number of shares which will satisfy the condition attached.

2) **Share price target** is one of the market related condition and hence it will be considered in the measurement of fair value at initial recognition (equity & cash settled) and at subsequent dates (in case of cash settled).

3) **Additional 4-months** requirement does not have any impact on eligibility to get share based payment. Therefore, it is a non -vesting condition and will be considered in fair value of the share based payment.

2.8 GRANT DATE

Definition of Grant date

"The date at which the entity and another party (including an employee) **agrees** to a share-based payment arrangement, being when the entity and the counterparty have a **shared understanding** of the terms and conditions of the arrangement. At grant date the entity confers on the counterparty the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met. If that agreement is subject to an **approval process** (for example, by shareholders), grant date is the date when that approval is obtained".

Analysis of the definition of the Grant date

- It is crucial to determine grant date correctly for determination of fair value of share based payment and its accounting.
- There must be an agreement between the employee/ supplier and the entity with clear communication of the terms and conditions of such share based payment. The date of such agreement will be considered as grant date.
- If the agreement is subject to the approval of appropriate authorities, then the grant date will be the date of approval.

Example

Entity initiated a share based payment agreement in its board meeting and directed the supervisors to communicate the agreement to the employee. Consider the following scenarios to arrive at grant date:

1) Employees have not yet given his/her consent either implicitly or explicitly. However, entity has taken approval of the agreement in its General Meeting.
2) Employees have agreed to the terms implicitly/ explicitly. However, the approval process is under finalization.
3) Certain terms have not been specifically mentioned since they are based on some subjective conditions in future.

Now,

1) Even when the approval has been acquired, no consent has been given by an employee/ counterparty; therefore, grant date cannot be determined.
2) Even when the employee/ counterparty has agreed to the terms but approval process is still not complete, hence the grant date should be the date when approvals are complete.
3) Terms/ conditions mentioned in the agreement must be objectively defined and should not be based on subjective outcome. Mutual understanding is crucial which essentially means that all terms/ clauses and calculation related to the equity prices must be clear and objectively defined.

Illustration 7 - Equity Settled – Non market conditions

Ankita Holding Inc. grants 100 shares to each of its 500 employees on 1st January, 20X1. The employees should remain in service during the vesting period. The shares will vest at the end of the

First year if the company's earnings increase by 12%;

Second year	*if the company's earnings increase by more than 20% over the two-year period;*
Third year	*if the entity's earnings increase by more than 22% over the three-year period.*

The fair value per share at the grant date is ₹ 122. In 20X1, earnings increased by 10%, and 29 employees left the organisation. The company expects that the shares will vest at the end of the year 20X2. The company also expects that additional 31 employees will leave the organisation in the year 20X2 and that 440 employees will receive their shares at the end of the year 20X2. At the end of 20X2, company's earnings increased by 18%. Therefore, the shares did not vest. Only 29 employees left the organization during 20X2. Company believes that additional 23 employees will leave in 20X3 and earnings will further increase so that the performance target will be achieved in 20X3. At the end of the year 20X3, only 21 employees have left the organization. Assume that the company's earnings increased to desired level and the performance target has been met.

Determine the expense for each year and pass appropriate journal entries?

Solution

Since the earnings of the entity is non-market related, hence it will not be considered in fair value calculation of the shares given. However, the same will be considered while calculating number of shares to be vested.

Workings:

	20X1	20X2	20X3
Total employees	500	500	500
Employees left (Actual)	(29)	(58)	(79)
Employees expected to leave in the next year	(31)	(23)	-
Year end – No of employees	440	419	421
Shares per employee	100	100	100
Fair value of share at grant date	122	122	122
Vesting period	1/2	2/3	3/3
Expenses-20X1 (Note 1)	26,84,000		
Expenses-20X2 (Note 2)		7,23,867	
Expenses-20X3 (Note 3)			17,28,333

Note 1:

Expense for 20X1 = Number of employees x Shares per employee x Fair value of share x Proportionate vesting period

= 440 x 100 x 122 X ½ = 26,84,000

Note 2:

Expense for 20X2 = (Number of employees x Shares per employee x Fair value of share x Proportionate vesting period) – Expense recognized in year 20X1

= (419 x 100 x 122 x 2/3) – 26,84,000

= 7,23,867

Note 3:

Expense for 20X3 = (No of employees x Shares per employee x Fair value of share x Proportionate vesting period) – Expense recognized in year 20X1 and 20X2

= (421 x 100 x 122 x 3/3) – (26,84,000 + 7,23,867)

= 17,28,333.

Journal Entries

31st December, 20X1			
Employee benefits expenses	Dr.	26,84,000	
To Share based payment reserve (equity)			26,84,000
(Equity settled shared based payment expected vesting amount)			
31st December, 20X2			
Employee benefits expenses	Dr.	7,23,867	
To Share based payment reserve (equity)			7,23,867
(Equity settled shared based payment expected vesting amount)			
31st December, 20X3			
Employee benefits expenses	Dr.	17,28,333	
To Share based payment reserve (equity)			17,28,333
(Equity settled shared based payment expected vesting amount)			
Share based payment reserve (equity)	Dr.	51,36,200	
To Share Capital			51,36,200
(Share capital Issued)			

*****

Illustration 8 - Equity Settled – Non market conditions (Reversals)

ACC limited granted 10,000 share options to one of its managers. In order to get the options, the manager has to work for next 3 years in the organization and reduce the cost of production by 10% over the next 3 years.

Fair value of the option at grant date was ₹ 95

Cost reduction achieved-

Year 1	*12%*	*Achieved*
Year 2	*8%*	*Not expected to vest in future*
Year 3	*10%*	*Achieved*

How the expenses would be recorded?

Solution

It is a non-market related condition. Hence the target to achieve cost reduction would be taken while estimating the number of options to be vested.

Year	Options	Fair value		FV of the options vested
Year 1	10,000	95	1/3	3,16,667
Year 2	10,000	95	0	(3,16,667)
Year 3	10,000	95	3/3	9,50,000

The condition to achieve 10% cost reduction each was not fulfilled in the year 2 and there was no expectation to vest this non-market condition in future as well and hence earlier expense amount was reversed in year 2. Since in the year 3 the non-market condition was again met, hence all such expense will be charged to Profit and Loss.

*****

Illustration 9 - Equity Settled – Market based conditions

Apple Limited has granted 10,000 share options to one of its directors for which he must work for next 3 years and the price of the share should increase by 20% over next 3 years.

The share price has moved as per below details -

Year 1	*22%*
Year 2	*19%*
Year 3	*25%*

At the grant date, the fair value of the option was ₹ 120.

How should we recognize the transaction?

Solution

The share price movement is a market based vesting condition hence its expectations are taken into consideration while calculating the fair value of the option.

Even if the required market condition as required is not fulfilled, there is no requirement to reverse the expense previously booked.

Irrespective of the outcome of the market prices (as it is already taken care of in the fair value of the option), each period an amount of (120 x 10,000)/3 = ₹ 4,00,000 will be charged to profit and loss.

*****

2.9 SUBSEQUENT MEASUREMENT

2.9.1 Equity settled Share Based Payment

The entity shall recognise an amount for the goods or services received during the vesting period based on the best available estimate of the number of equity instruments expected to vest and shall revise that estimate, if necessary, if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates. On vesting date, the entity shall revise the estimate to equal the number of equity instruments that ultimately vested.

Equity will be credited by an additional amount (adjusted with re-estimation of expected vesting equity shares at each reporting period) and there will not be any change in the value credited to the equity.

Example

An entity issued 100 shares each to its 2,000 employees subject to service condition of next 3 years. Grant date fair value of the shares is ₹ 200 each. There is an expectation that employee will remain in service at the rate 95% at end of 1st year, however the expectation got revised at the end of 2nd year to 92% and again got revised to 88% at the end of the 3rd year.

Year end	% Vest	Expense (current period)	Cumulative expenses
First	95%	2,000 x 100 x 200 x 95% x 1/3 = 1,26,66,667	1,26,66,667
Second	92%	2,000 x 100 x 200 x 92% x 2/3 – 1,26,66,667 = 1,18,66,667	2,45,33,333
Third	88%	2,000 x 100 x 200 x 88% x 3/3 – 2,45,33,333 = 1,06,66,667	3,52,00,000

2.9.2 Cash-settled Share Based Payment

After the initial recognition of a liability to settle SBP in cash, at the end of each subsequent period the liability would be fair valued till the time it is settled.

Example

An entity issued 100 shares each to its 20 employees subject to service condition of next 3 years. The settlement is to be made in cash. Grant date fair value of the shares is ₹ 200 each. However the fair value as at end of 1st year, 2nd year & 3rd year were ₹ 180, ₹ 190, ₹ 220 respectively.

Year end	Vest	Expense (current period)	Cumulative expenses

First	1/3	20 x 100 x 180 x 1/3 = 1,20,000	1,20,000
Second	2/3	20 x 100 x 190 x 2/3 – 1,20,000= 1,33,333	2,53,333
Third	3/3	20 x 100 x 220 x 3/3 – 2,53,333 =1,86,667	4,40,000

2.10 MODIFICATION, CANCELLATION AND SETTLEMENTS

An entity might modify the terms and conditions on which the equity instruments were granted. For example, it might reduce the exercise price of options granted to employees (i.e. reprice the options), which increases the fair value of those options.

Analysis of the requirement of Modification, Cancellation and Settlements

- An entity shall recognize, as a minimum, the services measured at the grant date fair value unless vesting conditions are not fulfilled. If an entity modifies as award, it must recognize, at a minimum, cost of the original award as if the award was not modified. If modification increases fair value of the award, the entity must recognize that additional cost. The additional cost is spread over the period from the modification date until the vesting of modified options, which may differ from the vesting date of original award. Whether a modification increases or decreases the fair value of an award is determined at the modification date. If an entity modifies a vested option, it recognizes any additional fair value given on the modification date itself.
- This requirement is applicable irrespective of any modification of terms, cancellation or early settlement, if any.
- If a grant of equity instruments is cancelled or settled during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):

  a. the entity shall account for the cancellation or settlement as an acceleration of vesting, and shall therefore recognise immediately the amount that otherwise would have been recognised for services received over the remainder of the vesting period.

  b. any payment made to the employee on the cancellation or settlement of the grant shall be accounted for as the repurchase of an equity interest, ie as a deduction from equity, except to the extent that the payment exceeds the fair value of the equity instruments granted, measured at the repurchase date. Any such excess shall be recognised as an expense. However, if the share-based payment arrangement included liability components, the entity shall remeasure the fair value of the liability at the date of cancellation or settlement. Any payment made to settle the liability component shall be accounted for as an extinguishment of the liability.

  c. if new equity instruments are granted to the employee and on the date when those new equity instruments are granted, the entity identifies the new equity instruments granted as replacement equity instruments for the cancelled equity instruments, the entity shall account for the granting of replacement equity instruments in the same way as a modification of the original grant of equity instruments, in accordance with paragraph 27 of Ind AS 102 and the guidance in Appendix B of Ind AS 102. The incremental fair value granted is the difference between the fair value of the replacement equity instruments and the net fair value of the cancelled equity instruments, at the date the replacement equity instruments are granted. The net fair value of the cancelled equity instruments is their fair value, immediately before the cancellation, less the amount of any payment made to the employee on cancellation of the equity instruments that is accounted for as a deduction from equity in accordance with (b) above. If the entity does not identify new equity instruments granted as replacement equity instruments for the cancelled equity instruments, the entity shall account for those new equity instruments as a new grant of equity instruments

- If an entity or counterparty can choose whether to meet a non-vesting condition, the entity shall treat the entity's or counterparty's failure to meet that non-vesting condition during the vesting period as a cancellation.
- If an entity repurchases vested equity instruments, the payment made to the employee shall be accounted for as a deduction from equity, except to the extent that the payment exceeds the fair value of the equity instruments repurchased, measured at the repurchase date. Any such excess shall be recognised as an expense.

Illustration 10 – Modifications – Equity-settled share based payment

Marathon Inc. issued 150 share options to each of its 1,000 employees subject to the service condition of 3 years. Fair value of the option given was calculated at ₹ 129. Below are the details and activities related to the SBP plan-

Year 1: *35 employees left and further 60 employees are expected to leave*

Share options re-priced (as MV of shares has fallen) as the FV fell to ₹ 50.

After the re-pricing they are now worth ₹ 80, hence expense is expected to increase by ₹ 30.

Year 2: *30 employees left and further 36 employees are expected to leave*

Year 3: *39 employees left*

How the modification/ re-pricing will be accounted?

Solution

The re-pricing has been done at the end of year 1, and hence the increased expense would be spread over next 2 years equally.

Total increased value due to modification is	₹ 30	(1/2 weight each years)

	Year 1	Year 2	Year 3
Number of employees	1,000	1,000	1,000
Employee left	(35)	(65)	104
Expected to leave	(60)	(36)	____
Net employees	905	899	896
Options per employee	150	150	150
Fair value of the option	129	129	129
Period weight	1/3	2/3	3/3
Modification		30	30
Expense (original)	58,37,250	57,59,850	57,40,500
Modification	Nil	20,22,750	20,09,250
		(899x150x30x1/2)	(896x150x30x2/2)- 20,22,750)

*****

Illustration 11 - Cancellation- Equity Settled Share based payment

Anara Fertilisers Limited issued 2000 share options to its 10 directors for an exercise price of ₹ 100.The directors are required to stay with the company for next 3 years.

Fair value of the option estimated	*₹ 130*
Expected number of directors to vest the option	*8*

During the year 2, there was a crisis in the company and Management decided to cancel the scheme immediately. It was estimated further as below-

Fair value of option at the time of cancellation was	*₹ 90*
Market price of the share at the cancellation date was	*₹ 99*

There was a compensation which was paid to directors and only 9 directors were currently in employment. At the time of cancellation of such scheme, it was agreed to pay an amount of ₹ 95 per option to each of 9 directors.

How the cancellation would be recorded?

Solution

	Year 1	Year 2	
A)			
Expected directors to vest	8	9	
Fair value of option	130	130	
Number of options	2,000	2,000	
Total	20,80,000	23,40,000	
Expense weightage	1/3		Full, as it is cancelled
Expense for the year	6,93,333	16,46,667	Remaining amount since cancelled

B) Cancellation compensation	
Number of directors	9
Amount agreed to pay	95
Number of options/ director	2,000
Compensation amount (9 x 95 x 2,000) Also refer working notes 1 and 2	17,10,000

Working Notes:

1. Amount to be deducted from Equity

Number of directors	9
Fair value of option (at the date of cancellation)	90
Number of options/ director	2,000
Total	16,20,000

2. Amount transferred to Profit and Loss

Total cancellation compensation	17,10,000
Less: To deduct from Equity	(16,20,000)
Balance transferred to Profit and Loss	90,000

*****

2.11 FAIR VALUE CALCULATION

All the share based payment plans are recognized referring fair value at grant date and it is crucial to understand how the fair value is arrived and the specific guidance available in the standard.

Fair value which is required to be used is not just a quoted price of any security. There are some market related conditions and / or non-vesting conditions that would be considered in the determination of fair value. Hence to determine such fair value, one has to use valuation techniques. However, there is nothing specific which has been defined by the standard. Black-scholes pricing model and Binomial pricing model are being used widely and are also generally accepted.

Standard specify minimum inputs to be used while calculating the fair value.

All option pricing models take into account, as a minimum, the following factors:

(a) the exercise price of the option;

(b) the life of the option;

(c) the current price of the underlying shares;

(d) the expected volatility of the share price;

(e) the dividends expected on the shares (if appropriate); and

(f) the risk-free interest rate for the life of the option.

Exercise price, current price and life of the option are observable inputs and relatively easy to understand and value can be easily identified. However, other inputs which are required to be used as minimum can be detailed out as below:

1. **Expected early exercise:** If a share-based payment has service / performance conditions attached, then there is an underlying presumption that the share-based payment plan will vest and it is usually expected to settle / exercise when the current market price crosses exercise price of the plan. Some senior level employees normally tend to exercise options later than lower level employees. Since all expected exercise will not happen at the same time and it is difficult to establish a linear function for such behavior, hence Binomial model is generally used in such situations Alternatively, expected early exercise could be modelled in a similar option pricing model that uses contractual life as an input.

2. **Expected volatility:** Expected volatility is a measure of the amount by which a price is expected to fluctuate during a period. The measure of volatility used in option pricing models is the annualised standard deviation of the continuously compounded rates of return on the share over a period of time. Volatility is typically expressed in annualised terms that are comparable regardless of the time period used in the calculation, for example, daily, weekly or monthly price observations.

3. **Expected dividend:** Whether expected dividend should be taken into account when measuring the fair value of shares or options granted depends on whether the counterparty is entitled to dividend or dividend equivalents.

Example

If employees were granted options and are entitled to dividend on the underlying shares or dividend equivalents (which might be paid in cash or applied to reduce the exercise price) between grant date and exercise date, the options granted should be valued as if no dividend will be paid on the underlying shares, i.e. the input for expected dividend should be zero.

4. **Risk-free interest rate:** The risk-free interest rate is the implied yield currently available on zero-coupon government issues of the country in whose currency the exercise price is expressed, with a remaining term equal to the expected term of the option being valued (based on the option's remaining contractual life and taking into account the effects of expected early exercise). It may be necessary to use an appropriate substitute, if no such government issues exist or circumstances indicate that the implied yield on zero-coupon government issues is not representative of the risk-free interest rate (for example, in high inflation economies). Also, an appropriate substitute should be used if market participants would typically determine the risk-free interest rate by using that substitute, rather than the implied yield of zero-coupon government issues, when estimating the fair value of an option with a life equal to the expected term of the option being valued.

2.12 GROUP SHARE BASED PAYMENT PLAN

In practice, we have come across many cases where one member of the group (typically, the parent) has obligation to settle a share-based payment transaction in which services are provided to another member of the group (typically a subsidiary). For example, within a multinational group, shares in the listed parent entity may be granted to the employees of various subsidiary entities located around the world. In some other cases, a listed subsidiary may have obligation to settle a share-based payment transaction in which services are provided to another member of the group (including the parent). These transactions are within the scope of Ind AS 102 for the entity receiving the services. This is despite the fact that it is not a direct party to the arrangement between its group entity and its employee.

For share-based payment transactions among group entities, in its separate or individual financial statements, the entity receiving the goods or services shall measure the goods or services received as either an equity-settled or a cash-settled share-based payment transaction by assessing:

(a) the nature of the awards granted, and

(b) its own rights and obligations.

The amount recognised by the entity receiving the goods or services may differ from the amount recognised by the consolidated group or by another group entity settling the share-based payment transaction.

The entity receiving the goods or services shall measure the goods or services received as an equity-settled share-based payment transaction when:

(a) the awards granted are its own equity instruments, or

(b) the entity has no obligation to settle the share-based payment transaction.

The entity shall subsequently remeasure such an equity-settled share-based payment transaction only for changes in non-market vesting conditions. In all other circumstances, the entity receiving the goods or services shall measure the goods or services received as a cash-settled share-based payment transaction.

The entity settling a share-based payment transaction when another entity in the group receives the goods or services shall recognise the transaction as an equity-settled share-based payment transaction only if it is settled in the entity's own equity instruments. Otherwise, the transaction shall be recognised as a cash-settled share-based payment transaction.

Let's understand the basis of determination of the classification of share-based payment transactions in both separate financial statements and consolidated financial statements in various scenarios:

1. Parent issues its own shares for the share-based payment plan issued by its subsidiary

Since the subsidiary company do not have any obligation to settle the services/ goods which are being issued against the plan, hence it will be treated as equity-settled share based payment (for subsidiary).

- Parent would debit these shares as "Investment in Subsidiary" and credit its equity.
- Subsidiary will treat this as equity-settled share based payment plan and will debit its expenses (employee related cost) and credit the capital contribution from the Parent.

2. Subsidiary provides rights to its employees to get equity instruments of its parent

Subsidiary will account for this arrangement as cash-settled share-based payment plan since it has an obligation to settle the same in other than its own equity shares.

- Parent would consider the payment/ settlement which is being made by its subsidiary as credit to "Dividend Income" and debit to Expenses (employee related cost).
- Subsidiary would debit its retained earnings as "Dividend distribution" and credit Equity (being share issued).

3. Parent settles the transaction by paying cash value for share based payment plan issued by its subsidiary

Irrespective of the cash which is settled either based on Parent's equity or Subsidiary's equity, it will be treated as equity-settled share-based payment plan in case of separate financial statements of subsidiary because the subsidiary does not have any obligation to settle the payments.

2.13 DISCLOSURE

Standard requires an entity to disclose the following-

- Type and scope of agreement existing during the reporting period.
- Describing general terms & conditions of each type of share-based payment plans.
- The number of weighted average price of share option as outstanding with a movement of granted, vested, expired, exercised, cancelled and closing balance of share-based payment plans.
- The average share price of exercised options.
- The range of exercise prices and weighted average remaining contractual life of options outstanding at the end of reporting period.
- The valuation method used to estimate the fair value of the awards.
- The impact on Statement of Profit and Loss and Balance Sheet for such share-based payments.

TEST YOUR KNOWLEDGE

Questions

1. An entity issued 100 shares each to its 1,000 employees subject to service condition of next 2 years. Grant date fair value of the share is ₹ 195 each. There is an expectation 97% of the employees will remain in service at the end of 1^{st} year. However, at the end of 2^{nd} year the expected employees to remain in service would be 91% of the total employees. Calculate expense for the year 1 & 2?

2. An entity issued 50 shares each to its 170 employees subject to service condition of next 2 years. The settlement is to be made in cash. Grant date fair value of the share is ₹ 85 each, however, the fair value as at end of 1^{st} year, 2^{nd} year were ₹ 80 & ₹ 90 respectively. Calculate expense for years 1 and 2?

3. Company P is a holding company for company B. A group share-based payment is being organized in which Parent issues its own equity-shares for the employees of company B. The details are as below –

Number of employees of company B	**100**
Grant date fair value of share	₹ 87
Number of shares to each employee granted	25
Vesting conditions	Immediately

Pass the journal entry in the books of company P & company B?

4. Plastic manufacturing company "X" enters into an agreement with company "Y" to purchase 100 kg of fiber which will be settled in cash at an amount equal to 10 Shares of X. However, X can settle the contract at any time by paying an amount of current share price less market value of fiber. There is no intention to take delivery of such fiber. How the transaction would be evaluated under Ind AS 102?

5. Entity X acquired entity Y in a business combination as per Ind AS 103. There is an existing share-based plan in entity Y with a vesting condition for 3 years in which 2 years have already lapsed at the date of such business acquisition. Entity X agrees to replace the existing award for the employees of combined entity. The details are as below –

Acquisition date fair value of share-based payment plan	**₹ 300**
Number of years to vest after acquisition	1 year
Fair Value of award which replaces existing plan	₹ 400

Calculate the share-based payment values as per Ind AS 102?

6. An entity P issues share-based payment plan to its employees based on the below details:

Number of employees	**100**
Fair value at grant date	₹ 25
Market condition	Share price to reach at ₹ 30
Service condition	To remain in service until market condition is fulfilled
Expected completion of market condition	4 years

Define expenses related to such share-based payment plan in each year subject to the below scenarios-

a) Market condition if fulfilled in year 3, or

b) Market condition is fulfilled in year 5.

7. Entity X grants 10 shares each to its 1000 employees on the conditions as mentioned below-

- To remain in service & entity's profit after tax (PAT) shall reach to ₹ 100 million.
- It is expected that PAT should reach to ₹ 100 million by the end of 3 years.
- Fair value at grant date is ₹ 100.
- Employees expected for vesting right by 1st year 97%, then it revises to 95% by 2nd year and finally to 93% by 3rd year.

Calculate expenses for next 3 years in respect of share-based payment?

8. At 1st January, 20X0, Ambani Limited grants its CEO an option to take either cash amount equivalent to 800 shares or 990 shares. The minimum service requirement is 2 years. There is a condition to keep the shares for 3 years if shares are opted.

Fair values of the shares	₹
Share alternative fair value (with restrictions)	212
Grant date fair value on 1st January, 20X0	213
Fair value on 31st December, 20X0	220
Fair value on 31st December, 20X1	232

The key management exercises his cash option at the end of 20X2. Pass journal entries.

9. MINDA issued 11,000 share appreciation rights (SARs) that vest immediately to its employees on 1st April, 20X0. The SARs will be settled in cash. Using an option pricing model, at that date it is estimated that the fair value of a SAR is ₹ 100. SAR can be exercised any time until 31st March, 20X3. It is expected that out of the total employees, 94% at the end of period on 31st March, 20X1, 91% at the end of next year will exercise the option.

Finally, when these were vested i.e. at the end of the 3rd year, only 85% of the total employees exercised the option.

Fair value of SAR	₹
31st March, 20X1	132
31st March, 20X2	139
31st March, 20X3	141
Pass the Journal entries?	

Answers

1.

Year end	% Vest	Expense (current period)
FIRST	97%	100 x 1,000 x 195 x 97% x 1/2 = 94,57,500
SECOND	91%	100 x 1,000 x 195 x 91% x 2/2 – 94,57,500= 82,87,500

2.

Year end	Vest	Expense (current period)
FIRST	1/2	50 x 170 x 80 x 1/2 = 3,40,000
SECOND	2/2	50 x 170 x 90 x 2/2 – 3,40,000 = 4,25,000

- Liability will be re-measured at each reporting date.
- Fair value at the end of the year will be used.

3. <u>Books of Company P</u>

Investment in Company B	Dr.	₹ 2,17,500	
To Equity (Issue of Shares)			₹ 2,17,500

<u>Books of Company B</u>

Expense	Dr.	₹ 2,17,500	
To Capital contribution from Parent P			₹ 2,17,500

4. A non-financial item which is not intended to use for its expected purchases/ sale and could be settled at net value would be covered as per Ind AS 109 'Financial Instruments'. The transaction would not be accounted under Ind AS 102.

5. Pre-acquisition period = 2

Post-acquisition period = 1

Total fair value at acquisition date = ₹ 300

Value to be recorded as per business combination under Ind AS 103

= ₹ 300/3 x 2 = ₹ 200

Value to be recorded as per Ind AS 102 (**A**) = ₹ 300/3 x 1 = ₹ 100

Fair value of the replacement of such award = ₹ 400

Difference from acquisition date fair value (**B**) = ₹ 400 – ₹ 300

= ₹ 100

Total value to be accounted over vesting period as per Ind AS 102 = A + B

= ₹ 100 + ₹ 100

= ₹ 200.

6. Market conditions are required to be considered while calculating fair value at grant date. However, service conditions will be considered as per the expected vesting right to be exercised by the employees and would be re-estimated during vesting period. However, if the market related condition is fulfilled before it is expected then all remaining expenses would immediately be charged off. If market related condition takes longer than the expected period then original expected period will be followed.

a) Market condition is fulfilled in year 3:

Year 1	2,500/4 = 625
Year 2	2,500/4 = 625
Year 3	2,500-625-625=1,250
Year 4	NIL

b) Market condition is fulfilled in year 5:

Year 1	2,500/4 = 625
Year 2	2,500/4 = 625
Year 3	2,500/4 = 625
Year 4	2,500/4 = 625
Year 5	NIL

7. Entity's PAT is one of the non-market related condition and hence would be included while making an expectation of vesting shares and there is no requirement to make any changes in the non-market condition whether this is fulfilled or not because it has already been considered in the expectation of vesting rights at the end of each year.

Year -1	1,000 x 10 x 100 x 97% x1/3 = 3,23,333
Year-2	1,000 x 10 x 100 x 95% x 2/3 - 3,23,333 = 3,10,000
Year -3	1,000 x 10 x 100 x 93% x 3/3 - 6,33,333 = 2,96,667

8.

	1st January, 20X0	31st December, 20X0	31st December, 20X1
Equity alternative (990 x 212)	2,09,880		
Cash alternative (800 x 213)	1,70,400		
Equity option (2,09,880 – 1,70,400)	39,480		
Cash Option (cumulative) (using period end fair value)		88,000	1,85,600
Equity Option (cumulative)		19,740	39,480
Expense for the period			
Equity option		19,740	19,740
Cash Option		88,000	97,600
Total		1,07,740	1,17,340

Journal Entries

31st December, 20X0			₹
Employee benefits expenses	Dr.	1,07,740	
To Share based payment reserve (equity)			19,740
To Share based payment liability			88,000
(Recognition of Equity option and cash settlement option)			
31st December, 20X1			
Employee benefits expenses	Dr.	1,17,340	
To Share based payment reserve (equity)			19,740
To Share based payment liability			97,600
(Recognition of Equity option and cash settlement option)			
Share based payment liability	Dr.	1,85,600	
To Bank/ Cash			1,85,600
(Settlement in cash)			

9.

Period	Fair value	To be vested	Cumulative	Expense
Start	100	100%	11,00,000	11,00,000
Period 1	132	94%	13,64,880	2,64,880
Period 2	139	91%	13,91,390	26,510
Period 3	141	85%	13,18,350	(73,040)
				13,18,350

Journal Entries

1st April, 20X0			
Employee benefits expenses	Dr.	11,00,000	
To Share based payment liability			11,00,000
(Fair value of the SAR recognised)			
31st March, 20X1			
Employee benefits expenses	Dr.	2,64,880	
To Share based payment liability			2,64,880
(Fair value of the SAR re-measured)			
31st March, 20X2			
Employee benefits expenses	Dr.	26,510	
To Share based payment liability			26,510
(Fair value of the SAR re-measured)			
31st March, 20X3			
Share based payment liability	Dr.	73,040	
To Employee benefits expenses			73,040
(Fair value of the SAR reversed)			
Share based payment liability	Dr.	13,18,350	
To Cash			13,18,350
(Settlement of SAR)			

CHAPTER 6

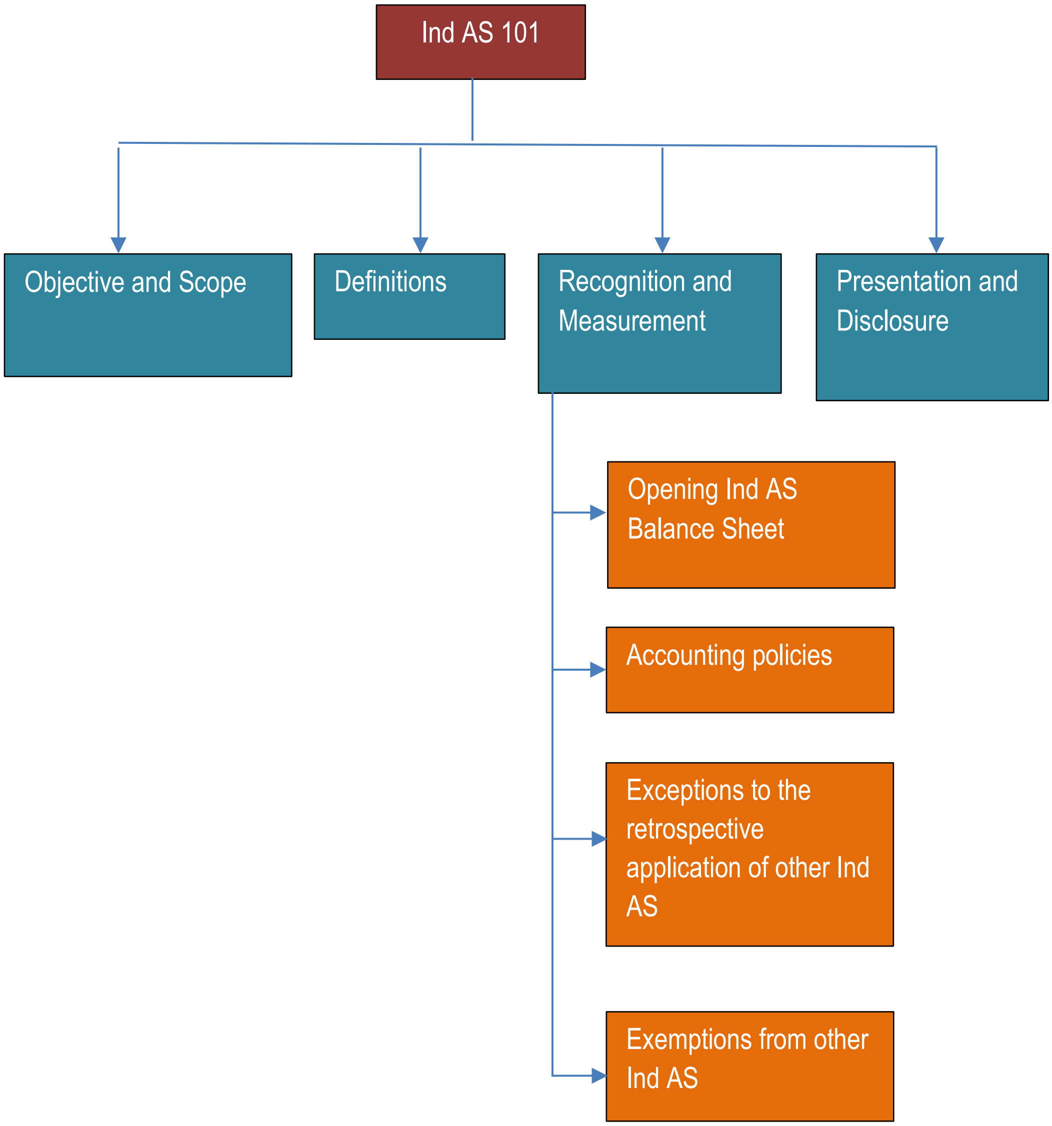
INDIAN ACCOUNTING STANDARD 101: FIRST-TIME ADOPTION OF IND AS

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the objective for issuing this standard.
- Appreciate the applicability and non-applicability of this standard
- Define the relevant terms like 'First Ind AS Financial Statements', 'First –time adopter', 'Opening Ind AS Balance sheet', 'Date of Transition to Ind AS', 'First Ind AS reporting period', 'Deemed cost' and 'Previous GAAP'.
- Apply the recognition and measurement principles in the preparation of opening Ind AS Balance Sheets
- Use the same accounting policies in its opening Ind AS Balance Sheet and throughout all periods presented in its first Ind AS financial statements.
- Evaluate the mandatory exceptions in which Ind AS prohibits retrospective application of Ind AS
- Examine when Ind AS 101 grants voluntary exemptions from some specific requirements of other Ind AS.
- Know the carve outs in Ind AS 101 from IFRS 1.

CHAPTER OVERVIEW



1. INTRODUCTION

Ind AS 101 prescribes the accounting principles for first - time adoption of Ind AS. It lays down various 'transition' requirements when a company adopts Ind AS for the first time, i.e., a move from Accounting Standards (Indian GAAP) to Ind AS.

Conceptually, the accounting under Ind AS should be applied retrospectively at the time of transition to Ind AS. However, to ease the process of transition, Ind AS 101 has given certain exemptions from retrospective application of Ind AS. The exemptions are broadly categorised into

- those which are mandatory in nature (i.e., cases where the company is not allowed to apply Ind AS retrospectively) and
- those which are voluntary in nature (i.e., the company may elect not to apply certain requirements of Ind AS retrospectively).

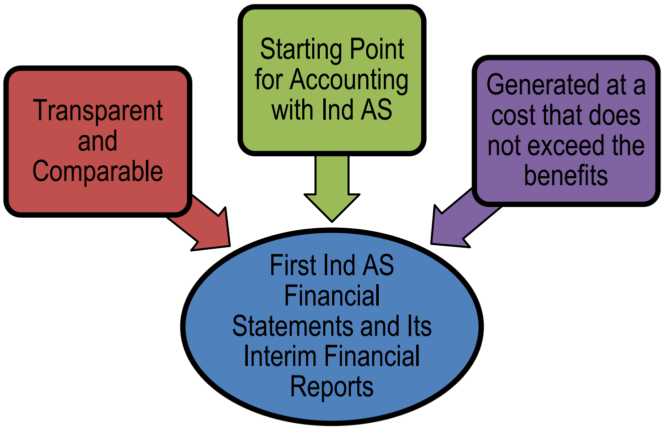
Ind AS 101 also prescribes presentation and disclosure requirements to explain the transition to the users of financial statements including explaining how the transition from Indian GAAP to Ind AS affected the company's financial position, financial performance and cash flows.

Ind AS 101 does not provide any exemption from the disclosure requirements in other Ind AS.

2. OBJECTIVE

The objective of this Ind AS is to ensure that an entity's first Ind-AS financial statements, and its interim financial reports for part of the period covered by those financial statements, contain high quality information that:

- is transparent for users and comparable;
- provides a suitable starting point; and
- at a cost that does not exceed the benefits.



3. DEFINITIONS

1. First Ind AS Financial Statements

- The first annual financial statements in which an entity adopts Ind AS, by an explicit and unreserved statement of compliance with Ind AS.
- This means compliance with ALL Ind-AS, partial compliance is not enough to make entity Ind AS compliant.

2. First –time adopter

- An entity that presents its first Ind AS financial statements, that entity is known as first time adopter

3. Opening Ind AS Balance sheet

- An entity's balance sheet at the date of transition to Ind AS

4. Date of Transition to Ind AS

- The beginning of the earliest period for which an entity presents full comparative information under Ind ASs in first Ind AS Financial statements.

5. First Ind AS reporting period

- The latest reporting period covered by an entity's first Ind AS financial statements

Example

XYZ Ltd. is a BSE listed company having net worth of ₹100 cr. XYZ Ltd. has to prepare financial statements as per Ind AS from 1st April 20X1.

The first Ind AS Financial Statements would be for period ending as on 31.03.20X2

First –time adopter- "XYZ Ltd" with effect from 01.04.20X1

Opening Ind AS Balance sheet – 01.04.20X0

Date of Transition to Ind ASs-01.04.20X0

First Ind AS reporting period-01.04.20X1 to 31.03.20X2

6. Deemed cost

An amount used as a surrogate for cost or depreciated cost at a given date. Subsequent depreciation or amortisation assumes that the entity had initially recognised the asset or liability at the given date and that its cost was equal to the deemed cost.

7. Previous GAAP

The basis of accounting that a first-time adopter used for its statutory reporting requirements in India immediately before adopting Ind AS. For instance, companies required to prepare their financial statements in accordance with Section 133 of the Companies Act, 2013, shall consider those financial statements as previous GAAP financial statements.

Illustration 1

Company B is a foreign subsidiary of Company A and has adopted IFRS as issued by IASB as its primary GAAP for its local financial reporting purposes. Company B prepares its financial statements as per Accounting Standards specified under Section 133 of the Companies Act, 2013 read with Rule 7 of the Companies (Accounts) Rules, 2014 for the purpose of consolidation with Company A. On transition of Company A to Ind-AS, what would be the previous GAAP of the foreign subsidiary Company B for its financial statements prepared for consolidation with Company A?

Solution

Ind AS 101 defines previous GAAP as the basis of accounting that a first-time adopter used for its statutory reporting requirements in India (emphasis added) immediately before adopting Ind AS. For instance, companies preparing their financial statements in accordance with the Accounting Standards specified under Section 133 of the Companies Act, 2013 read with Rule 7 of the Companies (Accounts) Rules, 2014 shall consider those financial statements as previous GAAP financial statements.

Accordingly, the previous GAAP of the foreign subsidiary for the purpose of consolidation under Ind-AS with the parent company would be accounting standards specified under Section 133 of the Companies Act, 2013 read with Rule 7 of the Companies (Accounts) Rules, 2014 and not the IFRS as issued by the IASB since the first time adoption has to be considered in the context of India only.

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4. SCOPE

Ind AS 101 Applies to:

- First Ind AS financial statements
- Each interim financial report for part of the period covered by its first Ind AS financial statements.

However, it does not apply to:

- Changes in accounting policies made by an entity that already applied Ind AS.

Illustration 2

E Ltd. is required to first time adopt Indian Accounting Standards (Ind AS) from April 1, 20X1. The management of E Ltd. has prepared its financial statements in accordance with Ind AS and an explicit and unreserved statement of compliance with Ind AS has been given by the management. However, the there is a disagreement on application of one Ind AS between the management and the auditor. Can such financial statements of E Ltd. be treated as first Ind AS financial statements?

Solution

Ind AS 101 defines first Ind AS financial statements as "The first annual financial statements in which an entity adopts Indian Accounting Standards (Ind AS), by an explicit and unreserved statement of compliance with Ind AS." In accordance with the above definition, if an explicit and unreserved statement of compliance with Ind AS has been given in the financial statements, even if the auditor's report contains a qualification because of disagreement on application of Indian Accounting Standard(s), it would be considered that E Ltd. has done the first time adoption of Ind AS. In such a case, exemptions given under Ind AS 101 cannot be availed again. If, however, the unreserved statement of compliance with Ind AS is not given in the financial statements, such financial statements would not be considered to be first Ind AS financial statements.

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5. RECOGNITION AND MEASUREMENT

5.1 Opening Ind AS Balance Sheet

An entity shall prepare and present an opening Ind AS balance sheet at the date of transition to Ind AS. This is the starting point for its accounting in accordance with Ind AS.

5.2 Accounting policies

Entity uses the same accounting policies in its opening Ind AS Balance Sheet and through all periods presented in its first Ind AS financial statements. Those accounting policies shall comply with each Ind AS effective at the end of its first Ind AS reporting period, subject to:

- Mandatory exceptions and
- Optional exemptions

An entity shall, in its opening Ind AS Balance sheet:

- Recognise all assets and liabilities whose recognition is required by Ind AS;
- Not recognise items as assets or liabilities if Ind AS do not permit such recognition;
- Reclassify items that it recognised in accordance with previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity in accordance with Ind AS; and
- Apply Ind AS in measuring all recognised assets and liabilities.

Example: Consistent application of latest version of Ind AS

The end of entity A's first Ind AS reporting period is 31 March 20X2. Entity A decides to present comparative information in those financial statements for one year only. Therefore, its date of transition to Ind AS is the beginning of business on 1 April 20X0 (or, equivalently, close of business on 31 March 20X0).

Entity A presented financial statements in accordance with its previous GAAP annually to 31 March each year up to, and including, 31 March 20X1.

Application of requirements

Entity A is required to apply the Ind AS effective for periods ending on 31 March 20X2 in:

a) preparing and presenting its opening Ind AS balance sheet at 1 April 20X0; and

b) preparing and presenting its balance sheet for 31 March 20X2 (including comparative amounts for the year ended 31 March 20X1), statement of profit and loss, statement of changes in equity and statement of cash flows for the year to 31 March 20X2 (including comparative amounts for the year ended 31 March 20X1) and disclosures (including comparative information for the year ended 31 March 20X1).

If a new Ind AS is not yet mandatory but permits early application, entity A is permitted, but not required, to apply that Ind AS in its first Ind AS financial statements.

Illustration 3

X Ltd. is required to adopt Ind AS from April 1, 20X1, with comparatives for one year, i.e., for 20X0-20X1. What will be its date of transition?

Solution

The date of transition for X Ltd. will be April 1, 20X0 being the beginning of the earliest comparative period presented. To explain it further, X Ltd. is required to adopt an Ind AS from April 1, 20X1, and it will give comparatives as per Ind AS for 20X0-20X1. Accordingly, the beginning of the comparative period will be April 1, 20X0 which will be considered as date of transition.

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Illustration 4

X Ltd. was using cost model for its property, plant and equipment (tangible fixed assets) till 31st March, 20X1 under previous GAAP. On 1st April, 20X0, i.e., the date of its transition to Ind AS, it used fair values as the deemed cost in respect of its Property, Plant & Equipment. Whether it will amount to a change in accounting policy?

Solution

Use of fair values on the date of transition will not tantamount to a change in accounting policy. The fair values of the property, plant and equipment on the date on transition will be considered as deemed cost without this being considered as a change in accounting policy.

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6. EXCEPTIONS/ EXEMPTIONS

There are two kinds of exceptions / exemptions in this Ind AS

1. Mandatory (Exceptions to the retrospective application of other Ind AS)
2. Optional (exemptions from application of other Ind AS)

6.1 Mandatory (Exceptions to the retrospective application of other Ind AS)

1. Estimates

An entity's estimates in accordance with Ind AS at the date of transition to Ind AS shall be consistent with estimates made for the same date in accordance with previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error.

Step 1 Estimates required by previous GAAP? If yes then go to Step 2 otherwise Step 3.

Step 2 Evidence of Error? If yes then go to Step 3 otherwise Step 4.

Step 3 Make estimate reflecting condition at relevant date.

Step 4 Consistent with Ind AS? If yes then go to step 5 otherwise Step 6

Step 5 Use previous estimates

Step 6 Use previous estimates and adjust to reflect Ind AS.

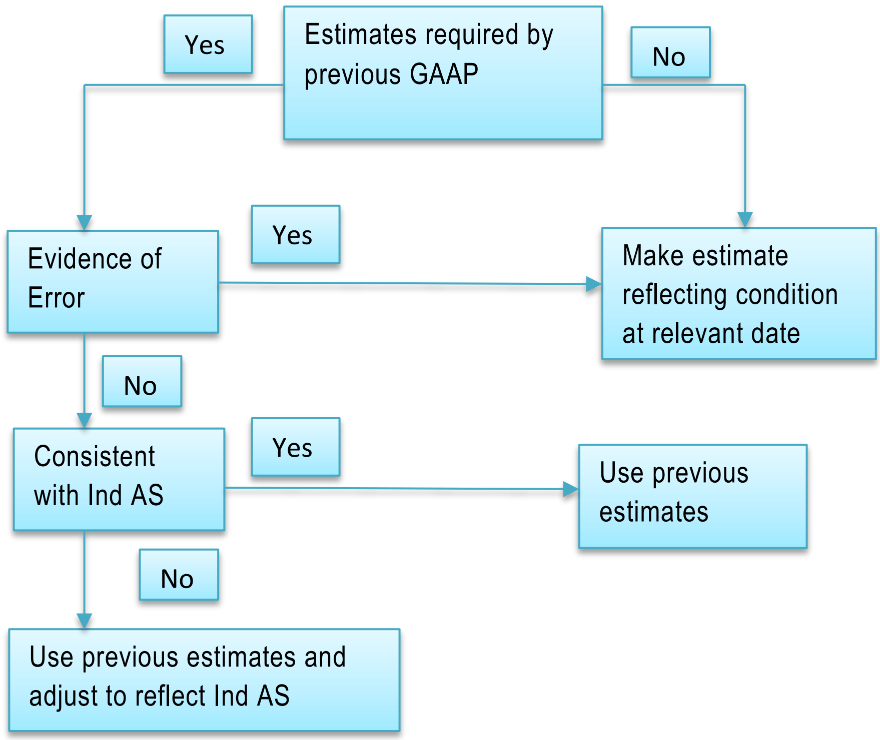

Illustration 5

A Ltd. acquired B Ltd. in a business combination transaction. A Ltd. agreed to pay certain contingent consideration (liability classified) to B Ltd. As part of its investment in its separate financial statements, A Ltd. did not recognise the said contingent consideration (since it was not considered probable) A Ltd. considered the previous GAAP carrying amounts of investment as its deemed cost on first-time adoption. In that case, does the carrying amount of investment required to be adjusted for this transaction?

Solution

In accordance with Ind AS 101, an entity has an option to treat the previous GAAP carrying values, as at the date of transition, of investments in subsidiaries, associates and joint ventures as its deemed cost on transition to Ind AS. If such an exemption is adopted, then the carrying values of such investments are not adjusted. Accordingly, any adjustments in relation to recognition of contingent consideration on first time adoption shall be made in the statement of profit and loss.

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2. **Derecognition of financial assets and liabilities**

A first-time adopter shall apply the derecognition requirements in Ind AS 109 **prospectively** for transactions occurring on or after the date of transition to Ind AS.

Example

If a first time adopter derecognised non-derivative financial assets or non-derivative financial liabilities in accordance with its previous GAAP as a result of a transaction that occurred before the date of transition to Ind AS, it shall not recognise those assets and liabilities in accordance with Ind AS (unless they qualify for recognition as a result of a later transaction or event).

An entity may apply the derecognition requirements in Ind AS 109 **retrospectively** from a date of the entity's choosing, provided that the information needed to apply Ind AS 109 to financial assets and financial liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.

3. **Hedge accounting**

At the date of transition to Ind AS an entity shall:

(a) measure all derivatives at fair value; and

(b) eliminate all deferred losses and gains arising on derivatives that were reported in accordance with previous GAAP as if they were assets or liabilities.

An entity shall not reflect in its opening Ind AS Balance Sheet a hedging relationship of a type that does not qualify for hedge accounting in accordance with Ind AS 109 (for example, many hedging relationships where the hedging instrument is a stand-alone written option or a net written option;

or where the hedged item is a net position in a cash flow hedge for another risk than foreign currency risk). However, if an entity designated a net position as a hedged item in accordance with previous GAAP, it may designate as a hedged item in accordance with Ind AS an individual item within that net position, or a net position if that meets the requirements in Ind AS 109, provided that it does so no later than the date of transition to Ind AS.

Ind AS 109 to discontinue hedge accounting. Transactions entered into before the date of transition to Ind ASs shall not be retrospectively designated as hedges.

4. **Non-controlling interests**

A first-time adopter shall apply the following requirements of Ind AS 110 prospectively from the date of transition to Ind AS:

a) Total comprehensive income is attributed to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance;

b) Accounting for changes in the parent's ownership interest in a subsidiary that do not result in a loss of control; and

c) Accounting for a loss of control over a subsidiary, and the related requirements of Ind AS 105, Non-current Assets Held for Sale and Discontinued operations.

However, if a first-time adopter elects to apply Ind AS 103 retrospectively to past business combinations, it shall also apply Ind AS 110 from that date.

Illustration 6

Ind AS requires allocation of losses to the non-controlling interest, which may ultimately lead to a debit balance in non-controlling interests, even if there is no contract with the non-controlling interest holders to contribute assets to the Company to fund the losses. Whether this adjustment is required or permitted to be made retrospectively?

Solution

In case an entity elects not to restate past business combinations, Ind AS 101 requires the measurement of non-controlling interests (NCI) to follow from the measurement of other assets and liabilities on transition to Ind AS. However, Ind AS 101 contains a mandatory exception that prohibits retrospective allocation of accumulated profits between the owners of the parent and the NCI. In case an entity elects not to restate past business combinations, the previous GAAP carrying value of NCI is not changed other than for adjustments made (remeasurement of the assets and liabilities subsequent to the business combination) as part of the transition to Ind AS. As such, the carrying value of NCI in the opening Ind AS balance sheet cannot have a deficit balance on account of recognition of the losses attributable to the minority interest, which was not recognised under the previous GAAP as part of NCI in the absence of contract to contribute assets to fund such a deficit. However, the NCI could have a deficit balance due to remeasurement of the assets and liabilities subsequent to the business combination as part of the transition to Ind AS. In case an entity restates past business combination, Ind AS 101 requires that the balance in NCI as at the date of transition shall be determined retrospectively in accordance with Ind AS, taking into account the impact of other elections made as part of the adoption of Ind AS. As such, the NCI could have a deficit balance on account of losses attributable to the NCI, even if there is no obligation on the holders of NCI to contribute assets to fund such a deficit.

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5. Classification and measurement of financial assets

An entity shall assess whether a financial asset meets the conditions of Ind AS 109 on the basis of the facts and circumstances that exist at the date of transition to Ind AS.

- If it is impracticable to assess a modified time value of money element in respect of financial asset, an entity shall assess the contractual cash flow characteristics of that financial asset on the basis of the facts and circumstances that existed at the date of transition to Ind AS without taking into account the requirements related to the modification of the time value of money element. An entity shall disclose the carrying amount at the reporting date of such financial assets until those financial assets are derecognized.
- If it is impracticable to assess whether the fair value of a prepayment feature is insignificant on the basis of the facts and circumstances that exist at the date of transition to Ind AS, an entity shall assess the contractual cash flow characteristics of that financial asset on the basis of the facts and circumstances that existed at the date of transition to Ind AS without taking into account the exception for prepayment features. An entity shall disclose the carrying amount at the reporting date of such financial assets until those financial assets are derecognised.
- If it is impracticable (as defined in Ind AS 8) for an entity to apply retrospectively the effective interest method in Ind AS 109, the fair value of the financial asset or the financial liability at the date of transition to Ind AS shall be the new gross carrying amount of that financial asset or the new amortised cost of that financial liability at the date of transition to Ind AS.

6. Impairment of financial assets

An entity shall apply the impairment requirements of Ind AS 109 retrospectively subject to

- At the date of transition to Ind AS, an entity shall use reasonable and supportable information that is available without undue cost or effort to determine the credit risk at the date that financial instruments were initially recognised.
- An entity is not required to undertake an exhaustive search for information when determining, at the date of transition to Ind AS, whether there have been significant increases in credit risk since initial recognition.
- If, at the date of transition to Ind ASs, determining whether there has been a significant increase in credit risk since the initial recognition of a financial instrument would require undue cost or effort, an entity shall recognise a loss allowance at an amount equal to lifetime expected credit losses at each reporting date until that financial instrument is derecognised, unless that financial instrument is low credit risk at a reporting date.

7. Embedded derivatives

A first-time adopter shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed at the later of the date it first became a party to the contract and the date a reassessment is required by Ind AS 109.

8. Government loans

A first-time adopter shall classify all government loans received as a financial liability or an equity instrument in accordance with Ind AS 32, Financial Instruments: Presentation.

A first-time adopter shall apply the requirements in Ind AS 109, Financial Instruments, and Ind AS 20, Accounting for Government Grants and Disclosure of Government Assistance, prospectively to government loans existing at the date of transition to Ind AS and shall not recognise the corresponding benefit of the government loan at a below-market rate of interest as a government grant.

An entity may apply the requirements in Ind AS 109 and Ind AS 20 retrospectively to any government loan originated before the date of transition to Ind AS, provided that the information needed to do so had been obtained at the time of initially accounting for that loan.

6.2 Optional (exemptions from application of other Ind AS)

1. Business combination

Ind AS 103 need not be applied to combinations before date of transition. But, if one combination is restated, all subsequent combinations are restated.

When the exemption is used

- There won't be any change in classification
- Assets and liabilities of past combination measured at carrying amount (deemed cost)
- Assets and liabilities measured at fair value restated at date of transition- adjusted retained earnings.

Note:

If an asset acquired, or liability assumed, in a past business combination was not recognised in accordance with previous GAAP, it does not have a deemed cost of zero in the opening Ind AS Balance Sheet. Instead, the acquirer shall recognise and measure it in its Consolidated Balance Sheet on the basis that Ind ASs would require in the Balance Sheet of the acquiree.

Example

If the acquirer had not, in accordance with its previous GAAP, capitalised leases acquired in a past business combination in which acquiree was a lessee, it shall capitalise those leases in its consolidated financial statements, as Ind AS 116, would require the acquiree to do in its Ind AS Balance Sheet.

Similarly, if the acquirer had not, in accordance with its previous GAAP, recognised a contingent liability that still exists at the date of transition to Ind AS, the acquirer shall recognise that contingent liability at that date unless Ind AS 37 would prohibit its recognition in the financial statements of the acquiree.

Conversely, if an asset or liability was subsumed in goodwill / capital reserve in accordance with previous GAAP but would have been recognised separately under Ind AS 103, that asset or liability remains in goodwill / capital reserve unless Ind AS would require its recognition in the financial statements of the acquiree.

Illustration 7

A Ltd. had made certain investments in B Ltd.'s convertible debt instruments. The conversion rights are substantive rights and would provide A Ltd. with a controlling stake over B Ltd. A Ltd. has evaluated that B Ltd. would be treated as its subsidiary under Ind AS and, hence, would require consolidation in its Ind AS consolidated financial statements. B Ltd. was not considered as a subsidiary, associate or a joint venture under previous GAAP. How should B Ltd. be consolidated on transition to Ind AS assuming that A Ltd. has opted to avail the exemption from retrospective restatement of past business combinations?

Solution

Ind AS 101 prescribes an optional exemption from retrospective restatement in relation to past business combinations. Ind AS 101 prescribes that when the past business combinations are not restated and a parent entity had not consolidated an entity as a subsidiary in accordance with its previous GAAP (either because it was not regarded as a subsidiary or no consolidated financial statements were required under previous GAAP), then the subsidiary's assets and liabilities would be included in the parent's opening consolidated financial statements at such values as would appear in the subsidiary's separate financial statements if the subsidiary were to adopt the Ind AS as at the parent's date of transition. For this purpose, the subsidiary's separate financial statements would be prepared as if it was a first-time adopter of Ind AS i.e. after availing relevant first-time adoption mandatory exceptions and voluntary exemptions. In other words, the parent will adjust the carrying amount of the subsidiary's assets and liabilities to the amounts that Ind AS would require in the subsidiary's balance sheet.

The deemed cost of goodwill equals the difference at the date of transition between:

(a) the parent's interest in those adjusted carrying amount; and

(b) the cost in the parent's separate financial statements of its investment in the subsidiary.

The measurement of non-controlling interest and deferred tax follows from the measurement of other assets and liabilities.

It may be noted here that the above exemption is available only under those circumstances where the parent, in accordance with the previous GAAP, has not presented consolidated financial statements for the previous year; or where the consolidated financial statements were prepared in accordance with the previous GAAP but the entity was not treated as a subsidiary, associate or joint venture under the previous GAAP. As such, if the consolidated financial statements were required to be prepared and there is a change in classification of the entity from subsidiary to associate or vice versa in accordance with Ind AS, then the above exemption does not apply.

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Illustration 8

A Ltd. has a subsidiary B Ltd. On first time adoption of Ind AS by B Ltd., it availed the optional exemption of not restating its past business combinations. However, A Ltd. in its consolidated financial statements has decided to restate all its past business combinations. Whether the amounts recorded by subsidiary need to be adjusted while preparing the consolidated financial statements of A Ltd. considering that A Ltd. does not avail the business combination exemption? Will the answer be different if the A Ltd. adopts Ind AS after the B Ltd?

Solution

As per Ind AS 101: "A first-time adopter may elect not to apply Ind AS 103 retrospectively to past business combinations (business combinations that occurred before the date of transition to Ind AS). However, if a first-time adopter restates any business combination to comply with Ind AS 103, it shall restate all later business combinations and shall also apply Ind AS 110 from that same date.

For example, if a first-time adopter elects to restate a business combination that occurred on 30 June 20X0, it shall restate all business combinations that occurred between 30 June 20X0 and the date of transition to Ind AS, and it shall also apply Ind AS 110 from 30 June 20X0." Based on the above, if A Ltd. restates past business combinations, it would have to be applied to all business combinations of the group including those by subsidiary B Ltd. for the purpose of Consolidated Financial Statements. Ind AS 101 states, "However, if an entity becomes a first-time adopter later than its subsidiary (or associate or joint venture) the entity shall, in its consolidated financial statements, measure the assets and liabilities of the subsidiary (or associate or joint venture) at the same carrying amounts as in the financial statements of the subsidiary (or associate or joint venture), after adjusting for consolidation and equity accounting adjustments and for the effects of the business combination in which the entity acquired the subsidiary." Thus, in case where the parent adopts Ind AS later than the subsidiary then it does not change the amounts already recognised by the subsidiary.

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2. Insurance contracts

Ind AS 104 will apply for annual periods beginning on or after date of transition to Ind AS.

If an insurer changes its accounting policies for insurance liabilities, it is permitted to reclassify some or all of its financial assets as FVTPL (fair value through profit or loss).

3. Share based payment transactions

Apply Ind AS 102, Share-based Payment, to equity instruments that vested before date of transition to Ind AS.

However, a first-time adopter may apply Ind AS 102 to equity instruments, if it has disclosed publicly the fair value of those equity instruments, determined at the measurement date.

It is encouraged to apply Ind AS 102 to liabilities arising from share-based payment transactions that were settled before the date of transition to Ind AS.

Illustration 9

X Ltd. is a first time adopter of Ind AS. The date of transition is April 1, 20X1. It has given 200 stock options to its employees. Out of these, 75 options have vested on November 30, 20X0 and the remaining 125 will vest on November 30, 20X1. What are the options available to X Ltd. at the date of transition?

Solution

Ind AS 101 provides that a first-time adopter is encouraged, but not required, to apply Ind AS 102 on 'Share-based Payment' to equity instruments that vested before the date of transition to Ind-AS. However, if a first time adopter elects to apply Ind AS 102 to such equity instruments, it may do so only if the entity has disclosed publicly the fair value of those equity instruments, determined at the measurement date, as defined in Ind AS 102.

Having regard to the above, X Ltd. has the following options:

- For 75 options that vested before the date of transition:
  - (a) To apply Ind AS 102 and account for the same accordingly, provided it has disclosed publicly the fair value of those equity instruments, determined at the measurement date, as defined in Ind AS 102.
  - (b) Not to apply Ind AS 102.

  However, for all grants of equity instruments to which Ind AS 102 has not been applied, i.e., equity instruments vested but not settled before date of transition to Ind AS, X Ltd. would still need to disclose the information.
- For 125 options that will vest after the date of transition: X Ltd. will need to account for the same as per Ind AS 102.

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4. Deemed cost for PPE and intangible assets

If an entity uses fair value in its opening Ind AS Balance Sheet as deemed cost for an item of property, plant and equipment, an intangible asset ***or a right-of-use asset***, the entity's first Ind AS financial statements shall disclose, for each line item in the opening Ind AS Balance Sheet:

(a) the aggregate of those fair values; and

(b) the aggregate adjustment to the carrying amounts reported under previous GAAP

A first-time adopter may elect to use a previous GAAP revaluation of an item of property, plant and equipment at, or before, the date of transition to Ind AS as deemed cost at the date of the revaluation, if the revaluation was, at the date of the revaluation, broadly comparable to:

(a) fair value; or

(b) cost or depreciated cost in accordance with Ind AS, adjusted to reflect, for example, changes in a general or specific price index.

For Investment Property

Ind AS 40, Investment Property permits only the cost model. Therefore, option of availing fair value as deemed cost for investment property is not available for first time adopters of Ind AS for its financial statements.

Illustration 10

X Ltd. is the holding company of Y Ltd. X Ltd. is required to adopt Ind AS from April 1, 20X1. X Ltd. wants to avail the optional exemption of using the previous GAAP carrying values in respect of its property, plant and equipment whereas Y Ltd. wants to use fair value of its property, plant and equipment as its deemed cost on the date of transition. Examine whether X Ltd. can do so for its consolidated financial statements. Also, examine whether different entities in a group can use different basis for arriving at deemed cost for property, plant and equipment in their respective standalone financial statements

Solution

Where there is no change in its functional currency on the date of transition to Ind AS, a first-time adopter to Ind AS may elect to continue with the carrying value of all of its property, plant and equipment as at the date of transition measured as per the previous GAAP and use that as its deemed cost at the date of transition after making necessary adjustments. If a first time adopter chooses this option then the option of applying this on selective basis to some of the items of property, plant and equipment and using fair value for others is not available. Nothing prevents different entities within a group to choose different basis for arriving at deemed cost for the standalone financial statements. However, in Consolidated Financial Statements, the entire group should be treated as one reporting entity. Accordingly, it will not be permissible to use different basis for arriving at the deemed cost of property, plant and equipment on the date of transition by different entities of the group for the purpose of preparing Consolidated Financial Statements.

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Illustration 11

For the purpose of deemed cost on the date of transition, an entity has the option of using the carrying value as the deemed cost. In this context, suggest which carrying value is to be considered as deemed cost: original cost or net book value? Also examine whether this would have any impact on future depreciation charge?

Solution

For the purpose of deemed cost on the date of transition, if an entity uses the carrying value as the deemed cost, then it should consider the net book value on the date of transition as the deemed cost and not the original cost because carrying value here means net book value. The future depreciation charge will be based on the net book value and the remaining useful life on the date of transition. Further, as per the requirements of Ind AS 16, the depreciation method, residual value and useful life need to be reviewed atleast annually. As a result of this, the depreciation charge may or may not be the same as the depreciation charge under the previous GAAP.

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Illustration 12

Is it possible for an entity to allocate cost as per the previous GAAP to a component based on its fair value on the date of transition even when it does not have the component-wise historical cost?

Solution

Yes, an entity can allocate cost to a component based on its fair value on the date of transition. This is permissible even when the entity does not have component-wise historical cost.

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Illustration 13

Revaluation under previous GAAP can be considered as deemed cost if the revaluation was, at the date of the revaluation, broadly comparable to fair value or cost or depreciated cost of assets in accordance with Ind AS, adjusted to reflect, e.g., changes in a general or specific price index. What is the acceptable time gap of such revaluation from the date of transition? Can adjustments be made to take effects of events subsequent to revaluation?

Solution

There are no specific guidelines in Ind AS 101 to indicate the acceptable time gap of such revaluation from the date of transition. The management of an entity needs to exercise judgement in this regard. However, generally, a period of 2–3 years may be treated as an acceptable time gap of such revaluation from the date of transition. In any case, adjustments should be made to reflect the effect of material events subsequent to revaluation.

*****

5. Cumulative translation difference

No need to:

- Recognise some translation differences in other comprehensive income.
- Reclassify cumulative translation differences for foreign operation from entity to profit or loss as part of gain or loss on its disposal

If first time adopter uses this exemption:

- Cumulative translation differences set to zero for all foreign operations.
- Gain/ loss on subsequent disposal of a foreign operation shall exclude these differences that arose before transition

A first time adopter may continue the policy adopted for accounting for exchange differences arising from long term monetary foreign currency items, as per previous GAAP.

Illustration 14

Y Ltd. is a first time adopter of Ind AS. The date of transition is April 1, 20X1. On the date of transition, there is a long- term foreign currency monetary liability of ₹ 60 crores (US $ 10 million converted at an exchange rate of US $ 1 = ₹ 21 60). The accumulated exchange difference on the date of transition is nil since Y Ltd. was following AS 11 notified under the Companies (Accounting Standards) Rules, 2006 and has not exercised the option provided in paragraph 46/46A of AS 11. The Company wants to avail the option under paragraph 46A of AS 11 prospectively or retrospectively on the date of transition to Ind AS. How should it account for the translation differences in respect of this item under Ind AS 101?

Solution

Ind AS 101 provides that a first-time adopter may continue the policy adopted for accounting for exchange differences arising from translation of long-term foreign currency monetary items recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP.

If the Company wants to avail the option prospectively

The Company cannot avail the exemption given in Ind AS 101 and cannot exercise option under paragraph 46/46A of AS 11, prospectively, on the date of transition to Ind AS in respect of Long term foreign currency monetary liability existing on the date of transition as the company has not availed the option under paragraph 46/46A earlier. Therefore, the Company need to recognise the exchange differences in accordance with the requirements of Ind AS 21, The Effects of Changes in Foreign Exchange Rates.

If the Company wants to avail the option retrospectively

The Company cannot avail the exemption given in Ind AS 101 and cannot exercise the option under paragraph 46/46A of AS 11 retrospectively on the date of transition to Ind AS in respect of long term foreign currency monetary liability that existed on the date of transition since the option is available only if it is in continuation of the accounting policy followed in accordance with the previous GAAP. Y Ltd. has not been using the option provided in Para 46/ 46A of AS 11, hence, it will not be permitted to use the option given in Ind AS 101 retrospectively.

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Illustration 15

Y Ltd. is a first time adopter of Ind AS. The date of transition is April 1, 20X5. On April 1, 20X1, it obtained a 7 year US$ 1,00,000 loan. It has been exercising the option provided in Paragraph 46/46A of AS 11 and has been amortising the exchange differences in respect of this loan over the balance period of such loan. On the date of transition, the company wants to continue the same accounting policy with regard to amortising of exchange differences. Whether the Company is permitted to do so?

Solution

Ind AS 101 provides that a first-time adopter may continue the policy adopted for accounting for exchange differences arising from translation of long-term foreign currency monetary items recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP. In view of the above, the Company can continue to follow the existing accounting policy of amortising the exchange differences in respect of this loan over the balance period of such long term liability.

*****

6. Investment in subsidiaries, joint ventures and associates

It is measured at cost, the cost may be :

- Cost determined in accordance with Ind AS 27 or
- Deemed cost (which may be fair value or previous GAAP carrying amount)

Illustration 16

A Ltd. acquired B Ltd. in a business combination transaction. A Ltd. agreed to pay certain contingent consideration (liability classified) to B Ltd. As part of its investment in its separate *financial statements, A Ltd. did not recognise the said contingent consideration (since it was not considered probable). A Ltd. considered the previous GAAP carrying amounts of investment as its deemed cost on first-time adoption. In that case, does the carrying amount of investment required to be adjusted for this transaction?*

Solution

In accordance with Ind AS 101, an entity has an option to treat the previous GAAP carrying values, as at the date of transition, of investments in subsidiaries, associates and joint ventures as its deemed cost on transition to Ind AS. If such an exemption is adopted, then the carrying values of such investments are not adjusted. Accordingly, any adjustments in relation to recognition of contingent consideration on first time adoption shall be made in the statement of profit and loss.

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7. Compound financial instruments

A first time adopter need not split the compound financial instruments into separate liability and equity component, if liability component not outstanding as at transition date.

Illustration 17

On April 1, 20X1, Sigma Ltd. issued 30,000 6% convertible debentures of face value of ₹ 100 per debenture at par. The debentures are redeemable at a premium of 10% on March 31, 20X5 or these may be converted into ordinary shares at the option of the holder. The interest rate for equivalent debentures without conversion rights would have been 10%. The date of transition to Ind AS is April 1, 20X3. Suggest how should Sigma Ltd. account for this compound financial instrument on the date of transition. The present value of ₹ 1 receivable at the end of each year based on discount rates of 6% and 10% can be taken as:

End of year	*6%*	*10%*
1	*0.94*	*0.91*
2	*0.89*	*0.83*
3	*0.84*	*0.75*
4	*0.79*	*0.68*

Solution

Ind AS 32, Financial Instruments: Presentation, requires an entity to split a compound financial instrument at inception into separate liability and equity components. If the liability component is no longer outstanding, retrospective application of Ind AS 32 would involve separating two portions of equity. The first portion is recognised in retained earnings and represents the cumulative interest accreted on the liability component. The other portion represents the original equity component. However, in accordance with this Ind AS, a first-time adopter need not separate these two portions if the liability component is no longer outstanding at the date of transition to Ind AS. In the present case, since the liability is outstanding on the date of transition, Sigma Ltd. will need to split the convertible debentures into debt and equity portion on the date of transition. Accordingly, we will first measure the liability component by discounting the contractually determined stream of future cash flows (interest and principal) to present value by using the discount rate of 10% p.a. (being the market interest rate for similar debentures with no conversion option).

	(₹)
Interest payments p.a. on each debenture	6
Present Value (PV) of interest payment for years 1 to 4 (6 × 3.17) (Note 1)	19.02
PV of principal repayment (including premium) 110 × 0.68 (Note 2)	74.80
Total liability component	93.82
Total equity component (Balancing figure)	6.18
Face value of debentures	100.00
Equity component per debenture	6.18
Total equity component for 30,000 debentures	1,85,400
Total debt amount (30,000 x 93.82)	28,14,600

Thus, on the date of transition, the amount of ₹ 30,00,000 being the amount of debentures will be split as under:

Debt	₹ 28,14,600
Equity	₹ 1,85,400

Notes:

1. 3.17 is PV of Annuity Factor of ₹ 1 at a discount rate of 10% for 4 years.
2. On maturity, ₹ 110 will be paid (₹ 100 as principal payment + ₹ 10 as premium)

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8. Fair value measurement of financial assets or financial liabilities

An entity may apply requirement of Ind AS 109 prospectively to transactions entered into on or after the date of transition.

9. Decommissioning liabilities included in Property Plant Equipment

An entity need not comply with the requirement for changes in such liabilities that accounted before the date of transition.

However, entity may measure liability as at the transition date as per Ind AS 37 and recognise its effect.

10. Designation of previously recognised financial instruments

An entity may designate any financial liability or asset at fair value through profit or loss at transition date.

Investment in equity may be designated at fair value through other comprehensive income at transition date.

If retrospectively application of effective interest method or impairment requirement is impracticable – fair value shall be new amortised cost of financial asset on the date of transition.

11. Existing financial liabilities with equity instruments

A first time adopter may apply Ind AS 109 from the date of transition to Ind AS.

12. Severe Hyperinflation

In hyperinflationary economy, when an entity's date of transition to Ind AS, is on, or after, the functional currency normalization date, then all assets and liabilities held before the functional currency normalization date may be measured at fair value on the date of transition.

This fair value may be used as deemed cost of those assets and liabilities in the opening Ind AS statement of financial position.

13. Leases

A first time adopter may determine whether an arrangement existing at the date of transition to Ind AS contain a ***lease (including classification of each land and building element as finance or an operating lease) on the basis of facts and circumstances existing on the date of transition.***

A lessee which is a first-time adopter of Ind AS shall recognise lease liabilities and right-of-use assets, by applying the following approach to all of its leases at the date of transition to Ind AS:

(a) measure a lease liability at the present value of the remaining lease payments discounted using the lessee's incremental borrowing rate at the date of transition to Ind AS;

(b) measure a right-of-use asset on a lease-by-lease basis <u>either</u> at:

(i) its carrying amount as if Ind AS 116 had been applied since the commencement date of the lease, but discounted using the lessee's incremental borrowing rate at the date of transition to Ind AS; or

(ii) an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the Balance Sheet immediately before the date of transition to Ind AS.

(c) apply Ind AS 36 to right-of-use assets.

A first-time adopter that is a lessee may do one or more of the following at the date of transition to Ind AS, applied on a lease-by lease basis:

(1) apply a single discount rate to a portfolio of leases with reasonably similar characteristics.

(2) elect not to apply the above requirements given in (a) to (c) to leases for which the lease term ends within 12 months of the date of transition to Ind AS. Instead, the entity shall account for (including disclosure of information about) these leases as if they were short-term leases accounted as per Ind AS 116.

(3) elect not to apply the above requirements given in (a) to (c) to leases for which the underlying asset is of low value. Instead, the entity shall account for (including disclosure of information about) these leases as per Ind AS 116.

(4) exclude initial direct costs from the measurement of the right-of-use asset at the date of transition to Ind AS.

(5) use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease.

14. Financial asset or intangible assets accounted for service concession arrangements

Change in accounting policy to be accounted retrospectively except for amortization policy in tangible assets relating to toll roads adopted as per previous GAAP.

If impracticable for an operator to apply the requirements of the Ind AS retrospectively at the date of transition to Ind AS, it shall recognise financial assets and intangible assets that existed at the date of transition to Ind AS using the previous carrying amounts.

15. Designation of contracts to buy or sell a non-financial item

An Entity may designate at the date of transition to Ind AS, contract that already exist on that date as measured at fair value through profit or loss but they meet the requirements of Ind AS 109 at the date and the entity designate all similar contracts.

16. Striping costs in the production of surface mine

A first time adopter may apply appendix to Ind AS 16 stripping costs in the production phase of a surface mine from the date of transition to Ind AS. As at the transition date to Ind AS, any previously recognised asset balance that resulted from stripping activity undertaken during the production phase shall be reclassified as a part of an existing asset to which the stripping activity related, to the extent that there remains an identifiable component of the core body with which the predecessor stripping asset can be associated.

17. Non-current assets held for sale and discounted operations

A first time adopter can:

- Measure noncurrent assets held for sale or discontinued operation at the lower carrying value and fair value less cost to sell at the date of transition to Ind AS in accordance with Ind AS 105; and
- Recognize directly in retain earnings any difference between that amount and the carrying amount of those assets at the date of transition to Ind AS determined under the entity's previous GAAP

18. Assets and liabilities of subsidiaries, associates and joint ventures

If a subsidiary becomes a first-time adopter later than its parent, the subsidiary shall measure its assets and liabilities at either:

- The carrying amounts that would be included in the parent's consolidated financial statements, based on the parent's date of transition to Ind AS. or
- The carrying amounts required by Ind AS 101, based on the subsidiary's date of transition to Ind AS.

If an entity becomes first time adopter later than its subsidiary, the entity shall measure the assets and liabilities at the subsidiary at the same carrying amounts as in the financial statements of the subsidiary, after adjusting for consolidation and equity accounting adjustments and for the effects of the business combination in which the entity acquired the subsidy.

19. Revenue from Contract with Customers

Any of the following exemption may be used in applying Ind AS 115 retrospectively:

- For completed contracts: Need not restate contracts that begin and end within the same annual reporting period;
- For completed contracts that have variable consideration: Option to use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods;
- For all reporting periods presented before the beginning of the first Ind AS reporting period, an entity need not disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when the entity expects to recognize that amount as revenue.

20. Joint arrangements:

Transition from Proportionate Consolidation to Equity Method

- To measure initial investment at transition date at the aggregate of carrying amount of assets and liabilities that had previously proportionately consolidated including goodwill arising on acquisition.
- To test the investment for impairment.
- If aggregate of all previously recognized assets/liabilities results in negative asset and if having legal or constructive obligation than recognize corresponding liability otherwise adjust retained earnings.

Transition from Equity Method to accounting for assets and liabilities

- To derecognize previous investment and recognize share of each asset and liability in respect of its interest in joint operation.
- Difference between amount as per Ind AS and previously recognized;
  (a) If carrying amount of previous investment is lower:

  Offset against goodwill relating to investment and thereafter retained earning

  (b) If carrying amount of previous investment is higher:

  Adjust against retained earning

Transitional provisions in entity's Separate FS

- To derecognise the investment and recognise assets and liabilities as per transition from equity method to accounting for assets and liabilities
- Provide reconciliation between amount derecognized, recognized and adjustment to retained earnings.

7. PRESENTATION AND DISCLOSURE

I. Comparative Information

- Ind AS does not require historical summaries to comply with the recognition and measurement requirement of Ind AS.
- In any financial statements containing historical summaries or comparative information in accordance with previous GAAP, an entity shall:
  - Label the previous GAAP information prominently as not being prepared in accordance with Ind AS; and

- Disclose the nature of the main adjustments that would make it comply with Ind AS. An entity need not quantify those adjustments.

II. Explanation of transition to Ind AS

- Reconciliation of

  (a) Equity from previous GAAP to Ind AS at transition and last year end;

  (b) Last year's total comprehensive income under previous GAAP to Ind AS.

- Sufficient detail to understand adjustments to each line item.
- Reconciliation to distinguish correction of errors identified during transition from change in accounting policy.
- Fair value as deemed cost and the amount of the adjustment.
- Ind AS 36 disclosures for impairment during transition.
- If adopted first time exemption option, to disclose the fact and accounting policy until such time those PPE, Intangible Assets, investment properties or intangible assets significantly depreciated/impaired/derecognized.
- Interim financial reports to include reconciliation with equity and profit or loss under previous GAAP.
- Further information to comply with Ind AS 34.

Illustration 18

H Ltd. has the following assets and liabilities as at March 31, 20X1, prepared in accordance with previous GAAP:

Particulars	***Notes***	***Amount (₹)***
Property, Plant & Equipment	*1*	*1,34,50,000*
Investments in S. Ltd.	*2*	*48,00,000*
Trade Receivables		*2,00,000*
Advances for purchase of inventory		*50,00,000*
Inventory		*8,00,000*
Cash		*49,000*
Total assets		*2,42,99,000*
VAT deferral loan	*3*	*60,00,000*
Creditors		*30,00,000*
Short term borrowing		*8,00,000*
Provisions		*12,00,000*
Total liabilities		*1,10,00,000*

Share capital		*1,30,00,000*
Reserves:		*2,99,000*
Cumulative translation difference	*4*	*1,00,000*
ESOP reserve	*4*	*20,000*
Retained earnings		*1,79,000*
Total equity		*1,32,99,000*
Total equity and liabilities		*2,42,99,000*

The following GAAP differences were identified by the Company on first-time adoption of Ind AS with effect from April 1, 20X1:

1. *In relation to property, plant and equipment, the following adjustments were identified:*
   - *Property, plant and equipment comprise land held for capital appreciation purposes costing ₹ 4,50,000 and was classified as investment property as per Ind AS 40.*
   - *Exchange differences of ₹ 1,00,000 were capitalised to depreciable property, plant and equipment on which accumulated depreciation of ₹ 40,000 was recognised.*
   - *There were no asset retirement obligations.*
   - *The management intends to adopt deemed cost exemption for using the previous GAAP carrying values as deemed cost as at the date of transition for PPE and investment property.*
2. *The Company had made an investment in S Ltd. (subsidiary of H Ltd.) for ₹ 48,00,000 that carried a fair value of ₹ 68,00,000 as at the transition date. The Company intends to recognise the investment at its fair value as at the date of transition.*
3. *Financial instruments:*
   - ***VAT deferral loan ₹ 60,00,000 :***

     The VAT deferral loan of ₹ 60,00,000 was obtained on March 31, 20X1, for setting up a business in a backward region with a condition to create certain defined targets for employment of local population of that region. The loan does not carry any interest and is repayable in full at the end of 5 years. In accordance with Ind AS 109, the discount factor on the loan is to be taken as 10%, being the incremental borrowing rate. Accordingly, the fair value of the loan as at March 31, 20X1, is ₹ 37,25,528. The entity chooses to exercise the option given in paragraph B11 of Ind AS 101, i.e., the entity chooses to apply the requirements of Ind AS 109, Financial Instruments and Ind AS 20, Accounting for Government Grants and Disclosure of Government Assistance, retrospectively as required information had been obtained at the time of initially accounting for VAT deferral loan

4. *The retained earnings of the Company contained the following:*

   - ***ESOP reserve of ₹ 20,000:***

     The Company had granted 1,000 options to employees out of which 800 have already vested. The Company followed an intrinsic value method for recognition of ESOP charge and recognised ₹ 12,000 towards the vested options and ₹ 8,000 over a period of time as ESOP charge and a corresponding reserve. If fair value method had been followed in accordance with Ind AS 102, the corresponding charge would have been ₹ 15,000 and ₹ 9,000 for the vested and unvested shares respectively. The Company intends to avail the Ind AS 101 exemption for share-based payments for not restating the ESOP charge as per previous GAAP for vested options.

   - ***Cumulative translation difference :***

     ₹ 1,00,000 The Company had a non-integral foreign branch in accordance with AS 11 and had recognised a balance of ₹ 1,00,000 as part of reserves. On first-time adoption of Ind AS, the Company intends to avail Ind AS 101 exemption of resetting the cumulative translation difference to zero.

Solution

Adjustments for opening balance sheet as per Ind AS 101

1. **Property, Plant & Equipment:** As the land held for capital appreciation purposes qualifies as investment property, such investment property should be reclassified from property, plant and equipment (PPE) to investment property and presented separately. As the Company has adopted the previous GAAP carrying values as deemed cost, all items of PPE and investment property should be carried at its previous GAAP carrying values. As such, the past capitalised exchange differences require no adjustment in this case.

2. **Investment in subsidiary:** On first time adoption of Ind AS, a parent company has an option to carry its investment in subsidiary at fair value as at the date of transition in its separate financial statements. As such, the company can recognise such investment at a value of ₹ 68,00,000.

3. **Financial instruments:** As the VAT deferral loan is a financial liability under Ind AS 109, that liability should be recognised at its present value discounted at an appropriate discounting factor. Consequently, the VAT deferral loan should be recognised at ₹ 37,25,528 and the remaining ₹ 22,74,472 would be recognised as deferred government grant.

4. **ESOPs:** Ind AS 101 provides an exemption of not restating the accounting as per the previous GAAP in accordance with Ind AS 102 for all options that have vested by the transition date. Accordingly, out of 1000 ESOPs granted, the first-time adoption exemption is available on 800 options that have already vested. As such, its accounting need not be restated. However, the 200 options that are not vested as at the transition date, need to be

restated in accordance with Ind AS 102. As such, the additional impact of ₹ 1,000 (i.e., 9,000 less 8,000) would be recognised in the opening Ind AS balance sheet.

5. **Cumulative translation difference :** As per paragraph D12 of Ind AS 101, the first-time adopter can avail an exemption regarding requirements of Ind AS 21 in context of cumulative translation differences. If a first-time adopter uses this exemption the cumulative translation differences for all foreign operation are deemed to be zero as at the transition date. In that case, the balance is transferred to retained earnings. As such, the balance of ₹ 1,00,000 should be transferred to retained earnings

6. **Retained earnings should be increased by ₹ 20,99,000 on account of the following:**

	₹
Increase in fair value of investment in subsidiary (note 2)	20,00,000
Additional ESOP charge on unvested options (note 4)	(1,000)
Transfer of cumulative translation difference balance to retained earnings (note 5)	1,00,000

After the above adjustments, the carrying values of assets and liabilities for the purpose of opening Ind AS balance sheet of Company H should be as under:

Particular	Notes	Previous	Adjustments	Ind AS GAAP
Non-Current Assets				
Property, Plant & Equipment	1	1,34,50,000	(4,50,000)	1,30,00,000
Investment property	1	0	4,50,000	4,50,000
Investment in S Ltd.	2	48,00,000	20,00,000	68,00,000
Advances for purchase of inventory		50,00,000		50,00,000
Current Assets				
Trade Receivables		2,00,000		2,00,000
Inventory		8,00,000		8,00,000
Cash		49,000		49,000
Total assets		2,42,99,000	20,00,000	2,62,99,000
Non-current Liabilities				
VAT deferral loan	3	60,00,000	(22,74,472)	37,25,528
Deferred government grant	3	0	22,74,472	22,74,472
Current Liabilities				
Creditors		30,00,000		30,00,000

Short term borrowing		8,00,000		8,00,000
Provisions		12,00,000		12,00,000
Total liabilities		1,10,00,000		1,10,00,000
Share capital		1,30,00,000		1,30,00,000
Reserves:				
Cumulative translation difference	5	1,00,000	(1,00,000)	0
ESOP reserve	4	20,000	1,000	21,000
Other reserves	6	1,79,000	20,99,000	22,78,000
Total equity		1,32,99,000	20,00,000	1,52,99,000
Total equity and liabilities		2,42,99,000	20,00,000	2,62,99,000

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8. CARVE OUTS IN IND AS 101 FROM IFRS 1

(i) Definition of previous GAAP under Ind AS 101

As per IFRS

IFRS 1 defines previous GAAP as the basis of accounting that a first - time adopter used immediately before adopting IFRS.

Carve out

Ind AS 101 defines previous GAAP as the basis of accounting that a first-time adopter used for its reporting requirement in India immediately before adopting Ind AS. The changes made it mandatory for Indian entities to consider the financial statements prepared in accordance with notified Accounting Standards as was applicable to them as previous GAAP when it transitions to Ind AS.

Reason

The change makes it mandatory for Indian companies to consider the financial statements prepared in accordance with Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006 as previous GAAP when it transitions to Ind AS as the law prevailing in India recognises the financial statements prepared in accordance with the Companies Act.

(ii) Allowing the use of carrying cost of Property, Plant and Equipment (PPE) on the date of transition of Ind AS 101

As per IFRS

IFRS 1 *First time Adoption of International Accounting Standards* provides that on the date of transition either the items of Property, Plant and Equipment shall be determined by applying IAS 16 *Property, Plant and Equipment* retrospectively or the same should be recorded at fair value.

Carve out

Paragraph D7AA of Ind AS 101 provides an additional option to use carrying values of all items of property, plant and equipment on the date of transition in accordance with previous GAAP as an acceptable starting point under Ind AS.

Reason

In case of old companies, retrospective application of Ind AS 16 or fair values at the date of transition to determine deemed cost may not be possible for old assets. Accordingly, Ind AS 101 provides relief to an entity to use carrying values of all items of property, plant and equipment on the date of transition in accordance with previous GAAP as an acceptable starting point under Ind AS.

(iii) Long Term Foreign Currency Monetary Items

As per IFRS

No provision in IFRS 1.

Carve out

Paragraph D13AA of Appendix D to Ind AS 101 provides that a first-time adopter may continue the policy adopted for accounting for exchange differences arising from translation of long-term foreign currency monetary items recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP. Consequently, Ind AS 21 also provides that it does not apply to long-term foreign currency monetary items for which an entity has opted for the exemption given in paragraph D13AA of Appendix D to Ind AS 101. Such an entity may continue to apply the accounting policy so opted for such long-term foreign currency monetary items.

Reason

Para 46A of AS 11 provides an option to recognise long term foreign currency monetary items in the statement of profit and loss as a part of the cost of property, plant and equipment or to defer its recognition in the statement of profit and loss over the period of loan in case the loan is not related to acquisition of fixed assets. To provide transitional relief, such entities have been given an option to continue the capitalisation or deferment of exchange differences, as the case may be, on foreign currency borrowings obtained before the beginning of first Ind AS reporting period.

(iv) Financial Assets or intangible assets accounted for in accordance with Appendix D, Service Concession Arrangements to Ind AS 115, Revenue from Contracts with Customers

As per IFRS

Paragraph D 22 of Appendix D to IFRS 1 provides that a first-time adopter may apply the transitional provisions in IFRIC 12 for account for financial assets or intangible assets.

Carve Out

Paragraph D 22 of Appendix D to Ind AS 101 provides that a first-time adopter may apply the following provisions while applying the Appendix D to Ind AS 115:

i) Subject to paragraph (ii), changes in accounting policies are accounted for in accordance with Ind AS 8, i.e. retrospectively, except for the policy adopted for amortization of intangible assets arising from service concession arrangements related to toll roads recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP.

ii) If, for any particular service arrangement, it is impracticable for an operator to apply this Appendix retrospectively at the date of transition to Ind AS, it shall:

(a) recognise financial assets and intangible assets that existed at the date of transition to Ind AS;

(b) use the previous carrying amounts of those financial and intangible assets (however previously classified) as their carrying amounts as at that date; and

(c) test financial and intangible assets recognised at that date for impairment, unless this is not practicable, in which case the amounts shall be tested for impairment as at the start of the current period.

iii) There are two aspects to retrospective determination: reclassification and remeasurement.

It will usually be practicable to determine retrospectively the appropriate classification of all amounts previously included in an operator's Balance Sheet, but that retrospective re-measurement of service arrangement assets might not always be practicable. However, the fact should be disclosed.

As a consequence to the above, paragraph 7AA has been inserted in Ind AS 38 to scope out the entity, to apply amortisation method, that opts to amortise the intangible assets arising from service concession arrangements in respect of toll roads recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS reporting period as per the exception given in paragraph D22 of Appendix D to Ind AS 101.

Reason

Schedule II to the Companies Act, 2013, allows companies to use revenue based amortisation of intangible assets arising from service concession arrangements related to toll roads while Ind AS 38, Intangible Assets, allows revenue based amortisation only in the circumstances in which the predominant limiting factor that is inherent in an intangible asset is the achievement of revenue threshold. In order to provide relief to such entities, Ind AS 38 and Ind AS 101 have been amended to allow the entities to continue to use the accounting policy adopted for amortization of intangible assets arising from service concession arrangements related to toll roads recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial statements. In other words, Ind AS 38 would be applicable to the amortisation of intangible assets arising from service concession arrangements related to toll roads entered into after the implementation of Ind AS.

TEST YOUR KNOWLEDGE

Questions

1. Company A intends to restate its past business combinations with effect from 30 June 20X0 (being a date prior to the transition date). If business combinations are restated, whether certain other exemptions, such as the deemed cost exemption for property, plant and equipment (PPE), can be adopted?

2. X Ltd. was using cost model for its property, plant and equipment till March 31, 20X2 under previous GAAP. The Ind AS become applicable to the company for financial year beginning April 1, 20X2. On April 1, 20X1, i.e., the date of its transition to Ind AS, it used fair value as the deemed cost in respect of its property, plant and equipment. X Ltd. wants to follow revaluation model as its accounting policy in respect of its property, plant and equipment for the first annual Ind AS financial statements. Whether use of fair values as deemed cost on the date of transition and use of revaluation model in the first annual Ind AS financial statements would amount to a change in accounting policy?

3. Y Ltd. is a first time adopter of Ind AS. The date of transition is April 1, 20X5. On April 1, 20X0, it obtained a 7 year US $ 1,00,000 loan. It has been exercising the option provided in Paragraph 46/46A of AS 11 and has been amortising the exchange differences in respect of this loan over the balance period of such loan. On the date of transition to Ind AS, Y Ltd. wants to discontinue the accounting policy as per the previous GAAP and follow the requirements of Ind AS 21 with respect to recognition of foreign exchange differences. Whether the Company is permitted to do so?

4. A company has chosen to elect the deemed cost exemption in accordance with Ind AS 101. However, it does not wish to continue with its existing policy of capitalising exchange fluctuation on long term foreign currency monetary items to property, plant and equipment i.e. it does not want to elect the exemption available as per Ind AS 101. In such a case, how would the company be required to adjust the foreign exchange fluctuation already capitalised to the cost of property, plant and equipment under previous GAAP?

Answers

1. Ind-AS 101 prescribes that an entity may elect to use one or more of the exemptions of the Standard. As such, an entity may choose to adopt a combination of optional exemptions in relation to the underlying account balances.

When the past business combinations after a particular date (30 June 20X0 in the given case) are restated, it requires retrospective adjustments to the carrying amounts of acquiree's assets and liabilities on account of initial acquisition accounting of the acquiree's net assets, the effects of subsequent measurement of those net assets (including amortisation of non-current assets that were recognised at its fair value), goodwill on consolidation and the consolidation adjustments. Therefore, the goodwill and equity (including non-controlling interest (NCI)) cannot be computed by considering the deemed cost exemption for PPE. However, the entity may adopt the deemed cost exemption for its property, plant and equipment other than those acquired through business combinations.

2. In the instant case, X Ltd. is using revaluation model for property, plant and equipment for the first annual Ind AS financial statements and using fair value of property, plant and equipment on the date of the transition, as deemed cost. Since the entity is using fair value at the transition date as well as in the first Ind AS financial statements, there is no change in accounting policy and mere use of the term 'deemed cost' would not mean that there is a change in accounting policy.

3. Ind AS 101 provides that a first-time adopter may continue the policy adopted for accounting for exchange differences arising from translation of long-term foreign currency monetary items recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP. Ind AS 101 gives an option to continue the existing accounting policy. Hence, Y Ltd. may opt for discontinuation of accounting policy as per previous GAAP and follow the requirements of Ind AS 21. The cumulative amount lying in the FCMITDA should be derecognised by an adjustment against retained earnings on the date of transition.

4. Ind AS 101 permits to continue with the carrying value for all of its property, plant and equipment as per the previous GAAP and use that as deemed cost for the purposes of first time adoption of Ind AS. Accordingly, the carrying value of property, plant and equipment as per previous GAAP as at the date of transition need not be adjusted for the exchange fluctuations capitalized to property, plant and equipment. Separately, it allows a company to continue with its existing policy for accounting for exchange differences arising from translation of long term foreign currency monetary items recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP. Accordingly, given that Ind AS 101 provides these two choices independent of each other, it may be possible for an entity to choose the deemed cost exemption for all of its property, plant and equipment and not elect the exemption of continuing the previous GAAP policy of capitalising exchange fluctuation to property, plant and equipment. In such a case, in the given case, a harmonious interpretation of the two exemptions would require the company to recognise the property, plant and equipment at the transition date at the previous GAAP carrying value (without any adjustment for the exchanges differences capitalized under previous GAAP) but for the purposes of the first (and all subsequent) Ind AS financial statements, foreign exchange fluctuation on all long term foreign currency borrowings would be recognised in the statement of profit and loss.

Annexure

DIVISION II OF SCHEDULE III TO THE COMPANIES ACT, 2013

Division II

Financial Statements for a company whose financial statements are drawn up in compliance of the Companies (Indian Accounting Standards) Rules, 2015.

GENERAL INSTRUCTIONS FOR PREPARATION OF FINANCIAL STATMENT OF A COMPANY REQUIRED TO COMPLY WITH Ind AS

1. Every company to which Indian Accounting Standards apply, shall prepare its financial statements in accordance with this Schedule or with such modification as may be required under certain circumstances.

2. Where compliance with the requirements of the Act including Indian Accounting Standards (except the option of presenting assets and liabilities in the order of liquidity as provided by the relevant Ind AS) as applicable to the companies require any change in treatment or disclosure including addition, amendment substitution or deletion in the head or sub-head or any changes inter se, in the financial statements or statements forming part thereof, the same shall be made and the requirements under this Schedule shall stand modified accordingly.

3. The disclosure requirements specified in this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Indian Accounting Standards. Additional disclosures specified in the Indian Accounting Standards shall be made in the Notes or by way of additional statement or statements unless required to be disclosed on the face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act, 2013 shall be made in the Notes in addition to the requirements set out in this Schedule.

4. (i) Notes shall contain information in addition to that presented in the Financial Statements and shall provide where required-

   (a) narrative description or disaggregation of items recognised in those statements; and

(b) information about items that do not qualify for recognition in those statements.

(ii) Each item on the face of the Balance Sheet, Statement of Changes in Equity and Statement of Profit and Loss shall be cross-referenced to any related information in the Notes. In preparing the Financial Statements including the Notes, a balance shall be maintained between providing excessive detail that may not assist users of Financial Statements and not providing important information as a result of too much aggregation.

5. Depending upon the turnover of the company, the figures appearing in the Financial Statements shall be rounded off as below:

Turnover	Rounding off
(i) less than one hundred crore rupees	To the nearest hundreds, thousands, lakhs or millions, or decimals thereof
(Ii) one hundred crore rupees or more	To the nearest, lakhs, millions or crores, or decimals thereof.

Once a unit of measurement is used, it should be used uniformly in the Financial Statements.

6. Financial Statements shall contain the corresponding amounts (comparatives) for the immediately preceding reporting period for all items shown in the Financial Statement including Notes except in the case of first Financial Statements laid before the company after incorporation.

7. Financial Statements shall disclose all 'material' items, i,e, the items if they could. individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size or nature of the item or a combination of both, to be judged in the particular circumstances.

8. For the purpose of this Schedule, the terms used herein shall have the same meanings assigned to them in Indian Accounting Standards.

9. Where any Act or Regulation requires specific disclosure to be made in the standalone financial statement of a company, the said disclosure shall be made in addition to those required under this Schedule.

Note: This Schedule sets out the minimum requirements for disclosure on the face of the Financial Statements, i.e, Balance Sheet, Statement of Changes in Equity for the period, the Statement of profit and Loss for the period (The term 'Statement of Profit and Loss' has the same meaning as Profit and Loss Account) and Notes. Cash flow statement shall be prepared, where applicable, in accordance with the requirement of the relevant Indian Accounting Standard.

Line items, sub-line items and sub-totals shall be presented as an addition or substitution on the face of the Financial Statements when such presentation is relevant to an understanding of the company's financial position or performance to cater to industry or sector-specific disclosure requirements or when required for compliance with the amendments to the Companies Act, 2013 or under the Indian Accounting Standards.

PART I -BALANCE SHEET

Name of the Company....................

Balance Sheet as at ....

(Rupees in.........)

	Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
	1	2	3	4
(1)	ASSETS			
	Non-current assets			
	(a) Property, Plant and Equipment (b) Capital work-in-progress (c) Investment Property (d) Goodwill (e) Other Intangible assets (f) Intangible assets under development (g) Biological Assets other than bearer plants (h) Financial Assets (i) Investments (ii) Trade receivables (iii) Loans (i) Deferred tax assets (net) (j) Other non-current assets			
(2)	Current assets (a) Inventories			

	(b) Financial Assets (i) Investments (ii) Trade receivables (iii) Cash and cash equivalents (iv) Bank balances other than (iii) above (v) Loans (vi) Others (to be specified) (c) Current Tax Assets (Net) (d) Other current assets			
	Total Assets			
	EQUITY AND LIABILITIES Equity (a) Equity Share capital (b) Other Equity			
(1)	LIABILITIES Non-current liabilities (a) Financial Liabilities (i) Borrowings (ii) Trade Payables: (A) total outstanding dues of micro enterprises and small enterprises; and (B) total outstanding dues of creditors other than micro enterprises and small enterprises. (iii) Other financial liabilities (other than those specified in item (b), to be specified) (b) Provisions (c) Deferred tax liabilities (Net) (d) Other non-current liabilities			

(2)	Current liabilities (a) Financial Liabilities (i) Borrowings (ii) Trade payables: (A) total outstanding dues of micro enterprises and small enterprises; and (B) total outstanding dues of creditors other than micro enterprises and small enterprises (iii) Other financial liabilities (other than those specified in item (c) (b) Other current liabilities (c) Provisions (d) Current Tax Liabilities (Net)			
	Total Equity and Liabilities			

see accompanying notes to the financial statements

STATEMENT OF CHANGES IN EQUITY

Name of the Company..............

Statement of Changes in Equity for the period ended ....

A. Equity Share Capital

Balance at the beginning of the reporting period	Changes in equity share capital during the year	Balance at the end of the reporting period

B. Other Equity

	Share application on money pending allotment	Equity component of compound financial instrument	Reserve and Surplus				Debt Instrument through other Comprehensive Income	Equity Instrument through Other Comprehensive Income	Effective portion of Cash Flow Hedges	Revaluation Surplus	Exchange difference on translating the financial statement	Other items of Other Comprehensive Income (Specify nature)	Money received against share capital	Total
			Capital Reserve	Securities Premium	Other Reserve (Specify nature)	Retained Earning								
Balance at the beginning of the reporting period														
Changes in accounting policy or prior period errors														
Restated balance at the beginning of the reporting period														
Total comprehensive Income for the year														
Dividends														
Transfer to retained earnings														
Any other change (to be specified)														
Balance at the end of the reporting period														

Note:

(i) Re-measurement of defined benefit plans and fair value changes relating to own credit risk of financial liabilities designated at fair value through profit or loss shall be recognised as a part of retained earning with separate disclosure of such items alongwith the relevant amounts in the Notes.

(ii) A description of the purposes of each reserve within equity shall be disclosed in the Notes.

GENERAL INSTRUCTIONS FOR PREPARATION OF BALANCE SHEET

1. An entity shall classify an asset as current when-
   (a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;
   (b) it holds the asset primarily for the purpose of trading;
   (c) it expects to realise the asset within twelve months after the reporting period; or
   (d) the asset is cash or a cash equivalent unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

   An entity shall classify all other assets as non-current.

2. The operating cycle of an entity is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents, When the entity's normal operating cycle is not clearly identifiable, it is assumed to be twelve months.

3. An entity shall classify a liability as current when-
   (a) it expects to settle the liability in its normal operating cycle;
   (b) it holds the liability primarily for the purpose of trading;
   (c) the liability is due to be settled within twelve months after the reporting period; or
   (d) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Terms of a liability that could, at the option of the counterparty, result in it settlement by the issue of equity instruments do not affect its classification.

   An entity shall classify all other liabilities as non-current.

4. A receivable shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.

5. A payable shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.

6. A company shall disclose the following in the Notes:

A Non-Current Assets

I. Property, Plant and Equipment

(i) Classification shall be given as:

(a) Land

(b) Buildings

(c) Plant and Equipment

(d) Furniture and Fixtures

(e) Vehicles

(f) Office equipment

(g) Bearer Plants

(h) Others (specify nature)

(ii) Assets under lease shall be separately specified under each class of assets

(iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses or reversals shall be disclosed separately.

II. Investment Property

A reconciliation of the gross and net carrying amounts of each class of property at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses or reversals shall be disclosed separately.

III. Goodwill

A reconciliation of the gross and net carrying amount of goodwill at the beginning and end of the reporting period showing additions, impairments, disposals and other adjustments.

IV. Other Intangible assets

(i) Classification shall be given as:

(a) Brands or trademarks

(b) Computer software

(c) Mastheads and publishing titles

(d) Mining rights

(e) Copyright, patents, other intellectual property rights, services and operating rights

(f) Recipes, formulae, models, designs and prototypes

(g) Licenses and franchises

(h) Others (specify nature)

(ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related amortization and impairment losses or reversals shall be disclosed separately.

V. Biological Assets other than bearer plants

A reconciliation of the carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments shall be disclosed separately.

VI. Investment

(i) Investments shall be classified as:

(a) Investments in Equity Instruments;

(b) Investments in Preference Shares;

(c) Investments in Government or trust securities;

(d) Investments in debentures or bonds;

(e) Investments in Mutual Funds;

(f) Investments in partnership firms; or

(g) Other investments (specify nature)

Under each classification, details shall be given of names of the bodies corporate that are-

(i) subsidiaries,

(ii) associates,

(iii) joint ventures, or

(iv) structured entities,

in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). Investment in partnership firms along with names of the firms, their partners, total capital and the shares of each partner shall be disclosed separately.

(ii) The following shall also be disclosed:

(a) Aggregate amount of quoted investment and market value thereof:

(b) Aggregate amount of unquoted investment: and

(c) Aggregate amount of impairment in value of investment.

VII. Trade Receivables

(i) Trade receivables shall be sub-classified as;

(a) Trade Receivables considered good - Secured;

(b) Trade Receivables considered good - Unsecured;

(c) Trade Receivables which have significant increase in Credit Risk; and

(d) Trade Receivables - credit impaired

(ii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iii) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

VIII. Loans

(i) Loans shall be classified as-

(a) Security Deposits;

(b) Loans to related parties (giving details thereof); and

(c) Other loans (specify nature).

(ii) Loans Receivables shall be sub-classified as:

(a) Loans Receivables considered good - Secured;

(b) Loans Receivables considered good - Unsecured;

(c) Loans Receivables which have significant increase in Credit Risk; and

(d) Loans Receivables - credit impaired;

The above shall also be separately sub-classified as-

(a) Secured, considered good;

(b) Unsecured, considered good; and

(c) Doubtful. Allowance for bad and doubtful loans shall be disclosed under the relevant heads separately.

(iv) Loans due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

IX. Bank deposits with more than 12 month maturity shall be disclosed under 'Other financial assets'

X. Other non-current asset: Other non-current assets shall be classified as

(i) Capital Advances; and

(ii) Advances other than capital advances;

(1) Advances other than capital advances shall be classified as:

(a) Security Deposits;

(b) Advances to related parties (giving details thereof; and

(c) Other advances (specify nature).

(2) Advances to directors or other officers of the company or any of them either severally or jointly with any other persons or advances to firms or private companies respectively in which any director is a partner or a director or a member should be separately stated, In case advances are of the nature of a financial asset as per relevant Ind AS, these are to be disclosed under other financial assets separately.

(iii) Others (specify nature).

B. Current Assets

I. Inventories

(i) Inventories shall be classified as-

(a) Raw materials;

(b) Work in-progress;

(c) Finished goods;

(d) Stock-in-trade (in respect of goods acquired for trading);

(e) stores and spares;

(f) Loose tools; and

(g) Others (specify nature).

(ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.

(iii) Mode of valuation shall be stated.

II. Investment

(i) Investments shall be classified as-

(a) Investments in Equity Instruments;

(b) Investment in Preference Shares;

(c) Investment in government or trust securities;

(d) Investments in debentures or bonds;

(e) Investments in Mutual Funds;

(f) Investment in partnership firms; and

(g) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate that are-

(i) subsidiaries,

(ii) associates,

(iii) joint ventures, or

(iv) structured entities,

in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid)

(ii) The following shall also be disclosed

(a) Aggregate amount of quoted investments and market value thereof;

(b) Aggregate amount of unquoted investments;

(c) Aggregate amount of impairment in value of investments,

III. Trade Receivables

(i) Trade receivables shall be sub-classified as:

(a) Trade Receivables considered good - Secured;

(b) Trade Receivables considered good - Unsecured;

(c) Trade Receivables which have significant increase in Credit Risk; and

(d) Trade Receivables - credit impaired.

(ii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iii) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or. private companies respectively in which any director is a partner or a director or a member should be separately stated.

IV. Cash and cash equivalents

Cash and cash equivalents shall be classified as-

a. Balances with Banks (of the nature of cash and cash equivalents);

b. Cheques, drafts on hand;

c. Cash on hand; and

d. Others (specify nature).

V. Loans

(i) Loans shall be classified as:

(a) Security deposits;

(b) Loans to related parties (giving details thereof); and

(c) others (specify nature).

(ii) Loans Receivables shall be sub-classified as:

(a) Loans Receivables considered good - Secured;

(b) Loans Receivables considered good - Unsecured;

(c) Loans Receivables which have significant increase in Credit Risk; and

(d) Loans Receivables - credit impaired.

(iii) Allowance for bad and doubtful loans shall be disclosed under the relevant heads separately.

(iv) Loans due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

VI. Other current assets (specify nature)

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.

Other current assets shall be classified as-

(i) Advances other than capital advances

(1) Advances other than capital advances shall be classified as:

(a) Security Deposits;

(b) Advances to related parties (giving details thereof);

(c) Other advances (specify nature)

(2) Advances to directors or other officers of the company or any of them either severally or jointly with any other persons or advances to firms or private

companies respectively in which any director is a partner or a director or a member should be separately stated.

(a) Earmarked balances with banks (for example for unpaid dividend) shall be separately stated.

(b) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(c) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

D. Equity

I. Equity Share Capital

For each class of equity share capital:

(a) the number and amount of shares authorised;

(b) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;

(c) par value per Share;

(d) a reconciliation of the number of shares outstanding at the beginning and at the end of the period;

(e) the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;

(f) shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;

(g) shares in the company held by each shareholder holding more than five per cent. shares specifying the number of shares held;

(h) shares reserved for issue under options and contracts or commitments for the sale of shares or disinvestment, including the terms and amounts;

(i) for the period of five years immediately preceding the date at which the Balance Sheet is prepared

- aggregate number and class of shares allotted as fully paid up pursuant to contract without payment being received in cash;
- aggregate number and class of shares allotted as fully paid up by way of bonus shares; and
- aggregate number and class of shares bought back;

(j) terms of any securities convertible into equity shares issued along with the earliest date of conversion in descending order starting from the farthest such date;

(k) calls unpaid (showing aggregate value of calls unpaid by directors and officers);

(l) forfeited shares (amount originally paid up).

II. Other Equity

(i) Other Reserves' shall be classified in the notes as-

(a) Capital Redemption Reserve;

(b) Debenture Redemption Reserve;

(c) Share Options Outstanding Account; and

(d) others- (specify the nature and purpose of each reserve and the amount in respect thereof);

(Additions and deductions since last balance sheet to be shown under each of the specified heads)

(ii) Retained Earnings represents surplus i.e. balance of the relevant column in the Statement of Changes in Equity;

(iii) A reserve specifically represented by earmarked investments shall disclose the fact that it is so represented;

(iv) Debit balance of Statement of Profit and Loss shall be shown as a negative figure under the head 'retained earnings'. Similarly, the balance of 'Other Equity', after adjusting negative balance of retained earnings, if any, shall be shown under the head 'Other Equity' even if the resulting figure is in the negative; and

(v) Under the sub-head 'Other Equity', disclosure shall be made for the nature and amount of each item.

E. Non-Current Liabilities

I. Borrowings

(i) borrowings shall be classified as-

(a) Bonds or debentures

(b) Term loans

(I) from banks

(II) from other Parties

(c) Deferred payment liabilities

(d) Deposits.

(e) Loans from related parties

(f) Long term maturities of finance lease obligations

(g) Liability component of compound financial instruments

(h) Other loans (specify nature);

(ii) borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed;

(iv) bonds or debentures (along with the rate of interest, and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be, where bonds/debentures are redeemable by installments, the date of maturity for this purpose must be reckoned as the date on which the first installment becomes due;

(v) particulars of any redeemed bonds or debentures which the company has power to reissue shall be disclosed;

(vi) terms of repayment of term loans and other loans shall be stated; and

(vii) period and amount of default as on the balance sheet date in repayment of borrowings and interest shall be specified separately in each case.

III. Provisions

The amounts shall be classified as-

(a) Provision for employee benefits; and

(b) Others (specify nature).

IV. Other non-current liabilities

(a) Advances; and

(b) Others (specify nature).

F. Current Liabilities

I. Borrowings

(i) Borrowings shall be classified as-

(a) Loans repayable on demand

(I) from banks

(II) from other parties

(b) Loans from related parties

(c) Deposits

(d) Other loans (specify nature);

(ii) borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case;

(iii) where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed;

(iv) period and amount of default as on the balance sheet date in repayment of borrowings and interest, shall be specified separately in each case.

II. Other Financial Liabilities

Other Financial liabilities shall be classified as-

(a) Current maturities of long-term debt;

(b) Current maturities of finance lease obligations;

(c) Interest accrued;

(d) Unpaid dividends;

(e) Application money received for allotment of securities to the extent refundable and interest accrued thereon;

(f) Unpaid matured deposits and interest accrued thereon;

(g) Unpaid matured debentures and interest accrued thereon; and

(h) Others (specify nature).

'Long term debt is a borrowing having a period of more than twelve months at the time of origination

III. Other current liabilities

The amounts shall be classified as-

(a) revenue received in advance;

(b) other advances (specify nature); and

(c) others (specify nature);

IV. Provisions

The amounts shall be classified as-

(i) provision for employee benefits; and

(ii) others (specify nature)

FA. Trade Payables

The following details relating to micro, small and medium enterprises shall be disclosed in the notes:

(a) the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year;

(b) the amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006 (27 of 2006), along with the amount of the payment made to the supplier beyond the appointed day during each accounting year;

(c) the amount of interest due and payable for the period of delay in making payment (which has been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006;

(d) the amount of interest accrued and remaining unpaid at the end of each accounting year; and 3

(e) the amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

Explanation.- The terms 'appointed day', 'buyer', 'enterprise', 'micro enterprise', 'small enterprise' and 'supplier', shall have the same meaning as assigned to them under clauses (b), (d), (e), (h), (m) and (n) respectively of section 2 of the Micro, Small and Medium Enterprises Development Act, 2006.

G. The presentation of liabilities associated with group of assets classified as held for sale and non-current assets classified as held for sale shall be in accordance with the relevant Indian Accounting Standards (Ind ASs)

H. Contingent Liabilities and Commitments (to the extent not provided for)

(i) Contingent Liabilities shall be classified as-

(a) claims against the company not acknowledged as debt;

(b) guarantees excluding financial guarantees; and

(c) other money for which the company is contingently liable.

(ii) Commitments shall be classified as-

(a) estimated amount of contracts remaining to be executed on capital account and not provided for;

(b) uncalled liability on shares and other investments partly paid; and

(c) other commitments (specify nature).

I. The amount of dividends proposed to be distributed to equity and preference shareholders for the period and title related amount per share shall be disclosed separately. Arrears of fixed cumulative dividends on irredeemable preference shares shall also be disclosed separately.

J. Where in respect of an issue of securities made for a specific purpose the whole or part of amount has not been used for the specific purpose at the Balance sheet date, there shall be indicated by way of note how such unutilised amounts have been used or invested.

7. When a company applies an accounting policy retrospectively or makes a restatement of items in the financial statements or when it reclassifies items in its financial statements, the company shall attach to the Balance Sheet, a "Balance Sheet" as at the beginning of the earliest comparative period presented.

8. Share application money pending allotment shall be classified into equity or liability in accordance with relevant Indian Accounting Standards. share application money to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable shall be separately shown under 'Other financial liabilities'.

9. Preference shares including premium received on issue, shall be classified and presented as 'Equity' or 'Liability' in accordance with the requirements of the relevant Indian Accounting Standards. Accordingly, the disclosure and presentation requirements in that regard applicable to the relevant class of equity or liability shall be applicable mutatis mutandis to the preference shares. For instance, plain vanilla redeemable preference shares shall be classified and presented under 'non-current liabilities' as 'borrowings' and the disclosure requirements in this regard applicable to such borrowings shall be applicable mutatis mutandis to redeemable preference shares.

10. Compound financial instruments such as convertible debentures, where split into equity and liability components, as per the requirements of the relevant Indian Accounting Standards, shall be classified and presented under the relevant heads in 'Equity' and 'Liabilities'

11. Regulatory Deferral Account Balances shall be presented in the Balance Sheet in accordance with the relevant Indian Accounting Standards.

PART II - STATEMENT OF PROFIT AND LOSS

Name of the Company.........................

Statement of Profit and Loss for the period ended................

	Particulars	Note No.	Figures as at the end of current reporting period	Figures for the previous reporting period
I	Revenue from operations			
II	Other Income			
III	Total Income (I + II)			
IV	EXPENSES Cost of materials consumed			
	Purchases of Stock-in-Trade			
	Changes in inventories of finished goods, Stock-in -Trade and work-in-progress			
	Employee benefits expense			
	Finance costs			
	Depreciation and amortization expenses			
	Other expenses			
	Total expenses (IV)			
V	Profit/(loss) before exceptional items and tax (I-IV)			
VI	Exceptional Items			
VII	Profit/ (loss) before exceptions items and tax(V-VI)			
VIII	Tax expense: (1) Current tax (2) Deferred tax			
IX	Profit (Loss) for the period from continuing operations (VII - VIII)			
X	Profit/(loss) from discontinued operations			

XI	Tax expenses of discontinued operations			
XII	Profit/(loss) from Discontinued operations (after tax) (X-XI)			
XIII	Profit/(loss) for the period (IX+XII)			
XIV	Other Comprehensive Income A. (i) Items that will not be reclassified to profit or loss (ii) Income tax relating to items that will not be reclassified to profit or loss B. (i) Items that will be reclassified to profit or loss (ii) Income tax relating to items that will be reclassified to profit or loss			
XV	Total Comprehensive Income for the period (XIII+XIV) Comprising Profit (Loss) and Other comprehensive Income for the period)			
XVI	Earnings per equity share (for continuing operation): (1) Basic (2) Diluted			
XVII	Earnings per equity share (for discontinued operation): (1) Basic (2) Diluted			
XVIII	Earning per equity share (for discontinued & continuing operation) (1) Basic (2) Diluted			

see accompanying notes to the financial statements

GENERAL INSTRUCTIONS FOR PREPARING OF STATEMENT OF PROFIT AND LOSS

1. The provisions of this Part shall apply to the income and expenditure account, in like manner as they apply to a Statement of Profit and Loss,
2. The Statement of Profit and Loss shall include:
   (1) Profit of loss for the Period;
   (2) Other Comprehensive Income for the period
   The sum of (1) and (2) above is “Total Comprehensive Income"
3. Revenue from operations shall disclose separately in the notes
   (a) sale of products (including Excise Duty);
   (b) sale of services; and
   (c) other operating revenues.
4. Finance Costs: Finance costs shall be classified as-
   (a) interest;
   (b) dividend on redeemable preference shares;
   (c) exchange differences regarded as an adjustment to borrowing costs; and
   (d) other borrowing costs (specify nature).
5. Other income: other income shall be classified as-
   (a) interest Income;
   (b) dividend Income; and
   (c) other non-operating income (net of expenses directly attributable to such income)
6. Other Comprehensive Income shall be classified into-
   (A) Items that will not be reclassified to profit or loss
      (i) Changes in revaluation surplus;
      (ii) Re-measurements of the defined benefit plans;
      (iii) Equity Instruments through Other Comprehensive Income;
      (iv) Fair value changes relating to own credit risk of financial liabilities designated at fair value through profit or loss;
      (v) Share of Other Comprehensive Income in Associates and Joint Ventures, to the extent not to be classified into profit or loss; and
      (v) Share of Other Comprehensive Income in Associates and Joint Ventures, to the extent not to be classified into profit or loss; and
      (vi) Others (specify nature).

(B) Items that will be reclassified to profit or loss;

(i) Exchange differences in translating the financial statements of a foreign operation;

(ii) Debt instruments through Other Comprehensive Income;

(iii) The effective portion of gains and loss on hedging instruments in a cash flow hedge;

(iv) Share of other comprehensive income in Associates and Joint Ventures, to the extent to be classified into profit or loss; and

(v) Others (specify nature)

7. Additional Information: A Company shall disclose by way of notes, additional information regarding aggregate expenditure and income on the following items:

(a) employee Benefits expense (showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) share based payments to employees, (iv) staff welfare expenses).

(b) depreciation and amortisation expense;

(c) any item of income or expenditure which exceeds one per cent of the revenue from operations or ₹ 10,00,000, whichever is higher, in addition to the consideration of 'materiality ‘as specified in clause 7 of the General Instructions for Preparation of Financial Statements of a Company;

(d) interest Income;

(e) interest Expense

(f) dividend income;

(g) net gain or loss on sale of investments;

(h) net gain or loss on foreign currency transaction and translation (other than considered as finance cost);

(i) payments to the auditor as (a) auditor, (b) for taxation matters, (c) for company law matters, (d) for other services, (e) for reimbursement of expenses;

(j) in case of companies covered under section 135, amount of expenditure incurred on corporate social responsibility activities; and

(k) details of items of exceptional nature;

8. Changes in Regulatory Deferral Account Balances shall be presented in the Statement of Profit and Loss in accordance with the relevant Indian Accounting Standards

PART III - GENERAL INSRUCTIONS FOR THE PREPARATION OF CONSOLIDATED FINANCIAL STATEMENTS

1. Where a company is required to prepare Consolidated Financial Statements, i.e,, consolidated balance sheet, consolidated statement of changes in equity and consolidated statement of profit and loss, the company shall mutatis mutandis follow the requirements of this Schedule as applicable to a company in the preparation of balance sheet, statement of changes in equity and statement of profit and loss .In addition, the consolidated financial statements shall disclose the information as per the requirements specified in the applicable Indian Accounting Standards notified under the Companies (Indian Accounting Standards) Rules 2015, including the following, namely:

   (i) Profit or loss attributable to 'non-controlling interest ‘and to ‘owners of the parent' in the statement of profit and loss shall be presented as allocation for the period Further, 'total comprehensive income for the period attributable to 'non-controlling interest' and to 'owners of the parent shall be presented in the statement of profit and loss as allocation for the period. The aforesaid disclosures for 'total comprehensive income shall also be made in the statement of changes in equity. In addition to the disclosure requirements in the Indian Accounting Standards, the aforesaid disclosures shall also be made in respect of 'other comprehensive Income

   (ii) 'Non-controlling interests' in the Balance Sheet and in the Statement of Changes in Equity, within equity, shall be presented separately from the equity of the 'owners of the parent'.

   (iii) Investments accounted for using the equity method.

2. In Consolidated Financial Statement, the following shall be disclosed by the way of additional information

Name of the entity in the Group	Net Asset i.e. total assets minus total liabilities		Share in profit or loss		Share in other comprehensive income		Share in total comprehensive income	
	As % of consolidated net assets	Amount	As % of consolidated profit or loss	Amount	As % of consolidated other comprehensive income	Amount	As % of total comprehensive income	Amount
Parent Subsidiaries Indian 1. 2. 3.								

Foreign 1. 2. 3. Non-Controlling Interest in all subsidiaries Associates (Investment as per the equity method) Indian 1. 2. 3. Foreign 1. 2. 3. Joint Venture (Investment as per the equity method) Indian 1. 2. 3. Foreign 1. 2. 3.								
Total								

3. All subsidiaries, associates and joint venture (whether Indian or Foreign) will be covered under consolidated financial statement.

4. An entity shall disclose the list of subsidiaries or associates or joint venture which have been consolidated in the consolidated financial statement along with the reason of not consolidating.

Final Course

(Revised Scheme of Education and Training)

Study Material

(Modules 1 to 4)

Paper 1

Financial Reporting

Module – 2

BOARD OF STUDIES

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SIGNIFICANT CHANGES

Significant changes in this Module 2 *vis-à-vis* Module 3 of November, 2018 edition of the Study Material

(The amendments made in the respective chapters / units have been highlighted in bold and italics for easy reference except newly added illustrations)

Chapter No.	Title of the chapter/Unit	Detail
9 unit 2	Ind AS 16	• Illustration 11 and 13 have been revised with respect to borrowing cost • Para 2.5.3.3 has been deleted
9 unit 3	Ind AS 116	• Newly added by withdrawing old unit on Ind AS 17
9 unit 4	Ind AS 23	• Para 4.3 and para 4.4.2 have been amended
9 unit 6	Ind AS 38	• Para 6.2.1, para 6.2.3, para 6.13 have been amended
9 unit 7	Ind AS 40	• Paras 7.2, 7.3, 7.4, 7.5, 7.6, 7.7, 7.10 have been amended (certain deletions and insertions made)
10	Ind AS 41	• Para 2 has been amended • Certain charts added

CONTENTS

DETAILED CONTENTS: MODULE – 2

CHAPTER 7: IND AS ON ASSETS OF THE FINANCIAL STATEMENTS

Unit 1: Indian Accounting Standard 2: Inventories

Contents:

Unit 2: Indian Accounting Standard 16: Property, Plant and Equipment

Contents:

Unit 3: Indian Accounting Standard 116: Leases

Contents:

Contents:

Unit 5: Indian Accounting Standard 36: Impairment of Assets

Contents:

Unit 6: Indian Accounting Standard 38: Intangible Assets

Contents:

Unit 7: Indian Accounting Standard 40: Investment Property

Contents:

Contents:

Contents:

CHAPTER 7

IND AS ON ASSETS OF THE FINANCIAL STATEMENTS

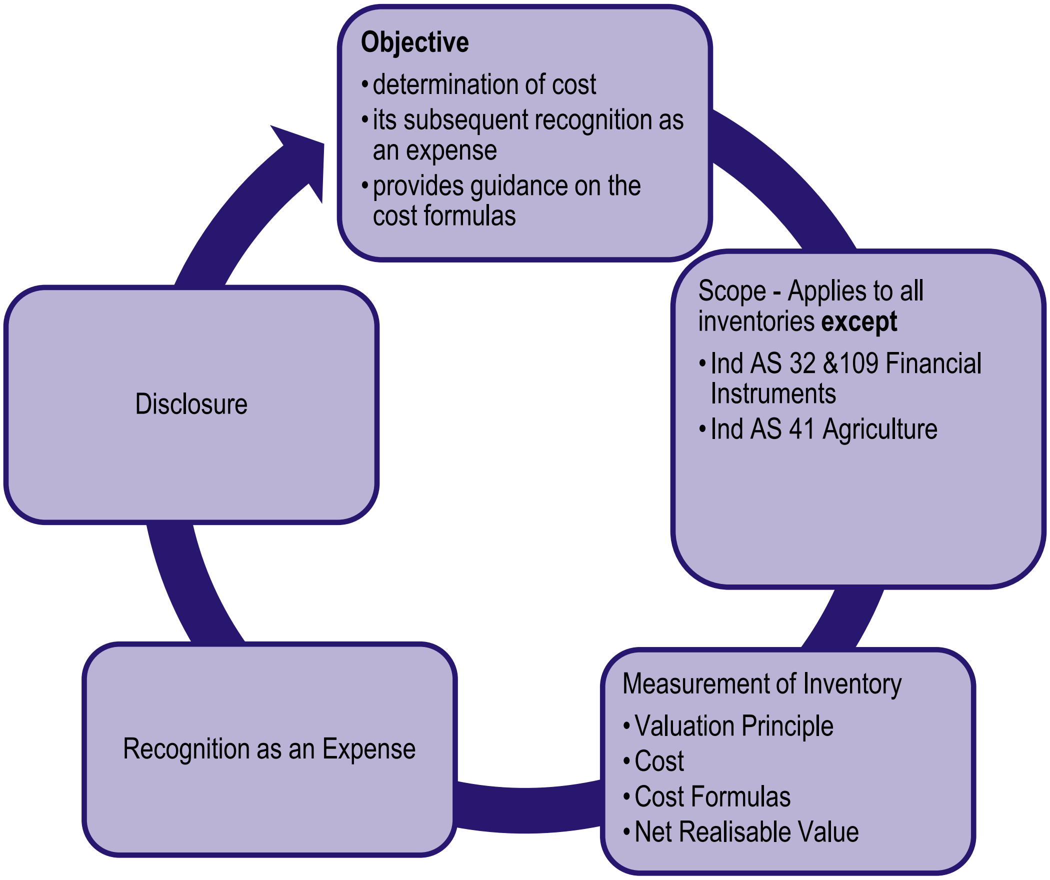
UNIT 1 : INDIAN ACCOUNTING STANDARD 2 : INVENTORIES

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand the objective and scope of this standard
- Define the terms inventories, net realisable value and fair value
- Determine the inventory cost
- Apply the cost formula for valuation of inventory
- Evaluate as how and when to perform write-downs to net realisable value
- Recognise the write downs as an expense

UNIT OVERVIEW



1.1 OBJECTIVE

The objective of this Standard is to prescribe the accounting treatment for inventories. This Standard provides the guidance for determining the cost of inventories and for subsequent recognition as an expense, including any write-down to net realisable value.

It provides guidance on the techniques for the measurement of cost, such as the standard cost method or retail method. It also outlines acceptable methods of determining cost, including specific identification, first-in-first-out and weighted average cost method.

1.2 SCOPE

- **This Standard is applicable to all inventories, except:**

  a) financial instruments (to be accounted under Ind AS 32, Financial Instruments: Presentation and Ind AS 109, Financial Instruments);

  b) biological assets (i.e. living animals or plants) related to agricultural activity and agricultural produce at the point of harvest (to be accounted under Ind AS 41, Agriculture);

- **This Standard does not apply to the measurement of inventories held by:**

  a) producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at net realisable value in accordance with well-established practices in those industries.

  When such inventories are measured at net realisable value, changes in that value are recognised in profit or loss in the period of the change

  b) commodity broker-traders who measure their inventories at fair value less costs to sell.

  When such inventories are measured at net realisable value/ fair value less costs to sell, changes in those values are to be recognised in profit or loss in the period of the change.

1.3 RELEVANT DEFINITIONS

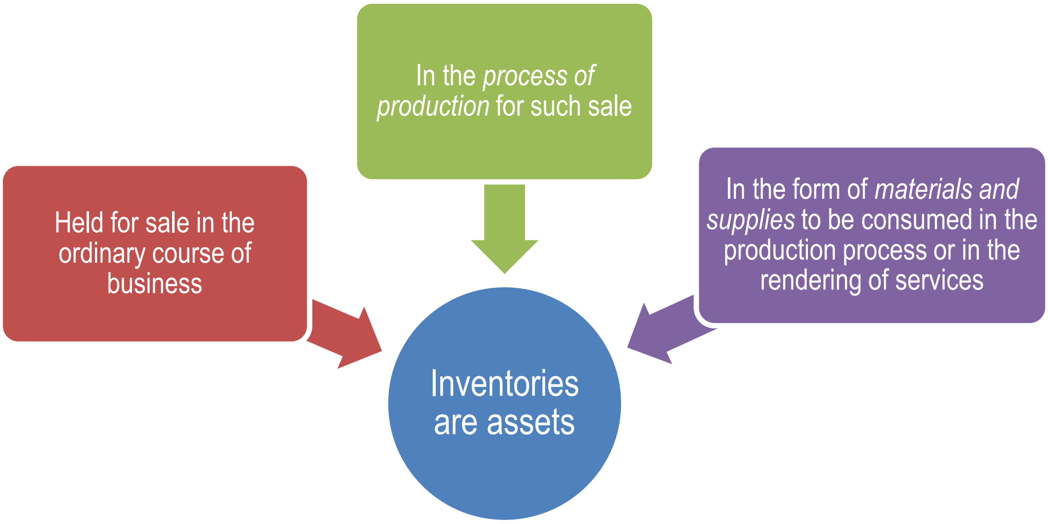
The following are the key terms used in this standard:

1) **Inventories** are assets:

a) held for sale in the ordinary course of business; (Finished Goods)

b) in the process of production for such sale; or (Work in progress)

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



2) Inventories encompass of:

a) goods purchased and held for resale (e.g. merchandise purchased by a retailer and held for resale, or land and other property held for resale);

b) finished goods produced, or work in progress being produced, by the entity; and includes

c) materials and supplies awaiting use in the production process.

Costs incurred to fulfill a contract with a customer that do not give rise to inventories are accounted as per Ind AS 115.

Illustration 1

As per Ind AS 2, inventories include 'materials and supplies awaiting use in the production process'. Whether packing material and publicity material are covered by the term 'materials and supplies awaiting use in the production process'.

Solution

While the primary packing material may be included within the scope of the term 'materials and supplies awaiting use in the production process' but the secondary packing material and publicity material cannot be so included, as these are selling costs which are required to be excluded as per Ind AS 2. For this purpose, the primary packing material is one which is essential to bring an item of inventory to its saleable condition, for example, bottles, cans etc., in case of food and beverages industry. Other packing material required for transporting and forwarding the material will normally be in the nature of secondary packing material.

*****

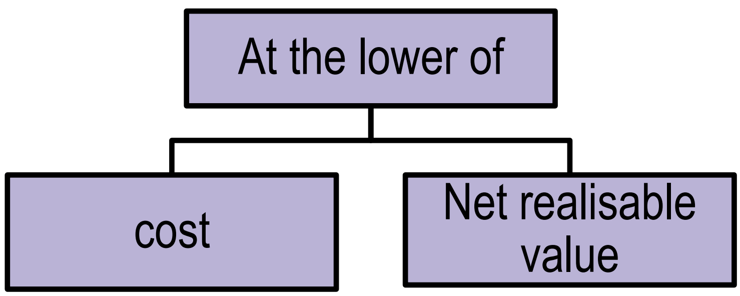
3) **Net realisable value** is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Net realisable value refers to the net amount that an entity expects to realize from the sale of inventory in the ordinary course of business. Fair value reflects the price at which an orderly transaction to sell the same inventory in the principal (or most advantageous) market for that inventory would take place between market participants at the measurement date. The former is an entity-specific value; the latter is not. Net realisable value for inventories may not equal fair value less costs to sell.

4) **Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (Ind AS 113, *Fair Value Measurement.*)

1.4 MEASUREMENT OF INVENTORIES

Inventories shall be measured at the lower of cost and net realisable value.



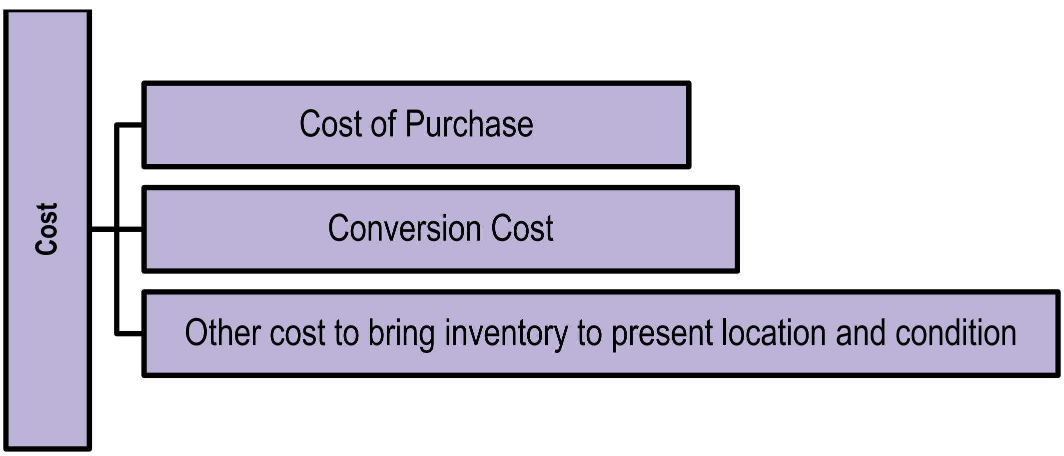
1) Cost of Inventories

Cost of Inventories comprises:

a) all costs of purchase;

b) costs of conversion; and

c) other costs incurred in bringing the inventories to their present location and condition.



2) Cost of purchase

The costs of purchase of inventories include:

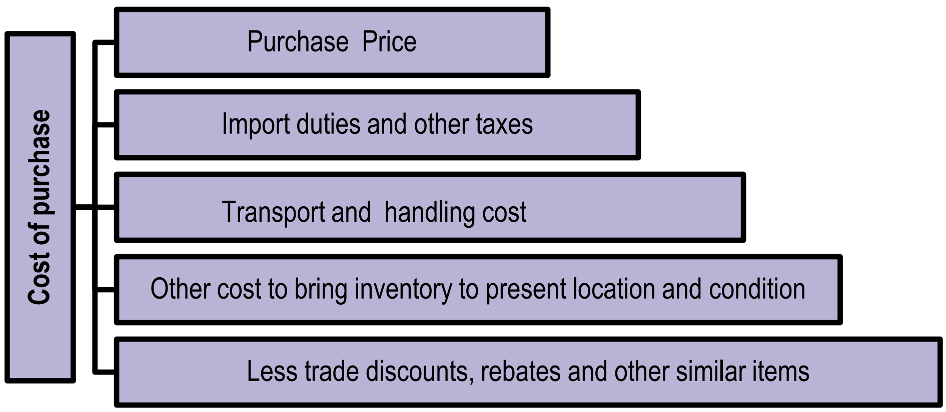
a) the purchase price,

b) import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities),

c) transport, handling and

d) other costs directly attributable to the acquisition of finished goods, materials and services.

Any trade discounts, rebates and other similar items are deducted in determining the costs of purchase of inventory.

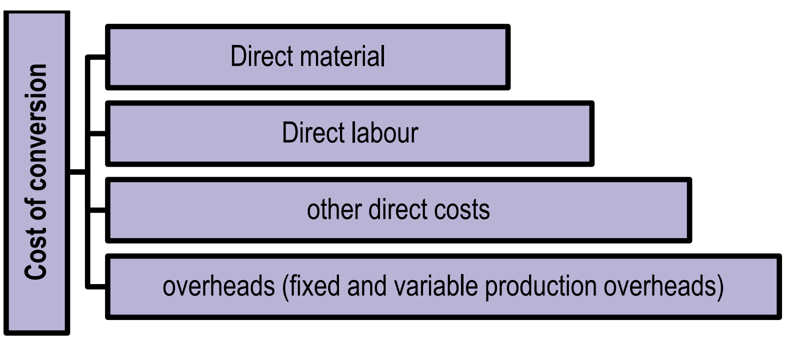


3) Cost of conversion

- The costs of conversion of inventories include costs directly related to the units of production, such as:

  a) direct material, direct labour and other direct costs; and

  b) a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods.



- Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings, equipment ***and right-of-use assets used in the production process***, and equipment, and the cost of factory management and administration.
- Allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity.
- When production levels are abnormally low, unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased so that inventories are not measured above cost.
- Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour. Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities.

Example:

Pluto ltd. has a plant with the normal capacity to produce 5,00,000 unit of a product per annum and the expected fixed overhead is ₹ 15,00,000. Fixed overhead on the basis of normal capacity is ₹ 3 per unit (15,00,000/5,00,000).

Case 1:

Actual production is 5,00,000 units. Fixed overhead on the basis of normal capacity and actual overhead will lead to same figure of ₹ 15,00,000. Therefore, it is advisable to include this on normal capacity.

Case 2:

Actual production is 3,75,000 units. Fixed overhead is not going to change with the change in output and will remain constant at ₹ 15,00,000, therefore, overheads on actual basis is ₹ 4 p/u (15,00,000/3,75,000).

Hence by valuing inventory at ₹ 4 each for fixed overhead purpose, it will be overvalued and the losses of ₹ 3,75,000 will also be included in closing inventory leading to a higher gross profit then actually earned.

Therefore, it is advisable to include fixed overhead per unit on normal capacity to actual production (3,75,000 x 3) ₹ 11,25,000 and balance ₹ 3,75,000 shall be transferred to Profit & Loss Account.

Case 3:

Actual production is 7,50,000 units. Fixed overhead is not going to change with the change in output and will remain constant at ₹ 15,00,000, therefore, overheads on actual basis is ₹ 2 (15,00,000/ 7,50,000).

Hence by valuing inventory at ₹ 3 each for fixed overhead purpose, we will be adding the element of cost to inventory which actually has not been incurred. At ₹ 3 per unit, total fixed overhead comes to ₹ 22,50,000 whereas, actual fixed overhead expense is only ₹ 15,00,000. Therefore, it is advisable to include fixed overhead on actual basis (7,50,000 x 2) ₹ 15,00,000.

4) Other costs

- Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition.
- Cost to be **excluded** from the cost of inventories and recognised as expenses in the period in which they are incurred are:

  a) abnormal amounts of wasted materials, labour or other production costs;

  b) storage costs, unless those costs are necessary in the production process before a further production stage;

  c) administrative overheads that do not contribute to bringing inventories to their present location and condition; and

  d) selling costs.
- The extent to which borrowing cost is included in the cost of inventories is determined on the basis of the requirement of Ind AS 23 Borrowing Costs.
- An entity may acquire inventories on deferred settlement terms. When the arrangement effectively contains a financing element, that element, for example a difference between the purchase prices for normal credit terms and the amount paid, is recognised as interest expense over the period of the financing.

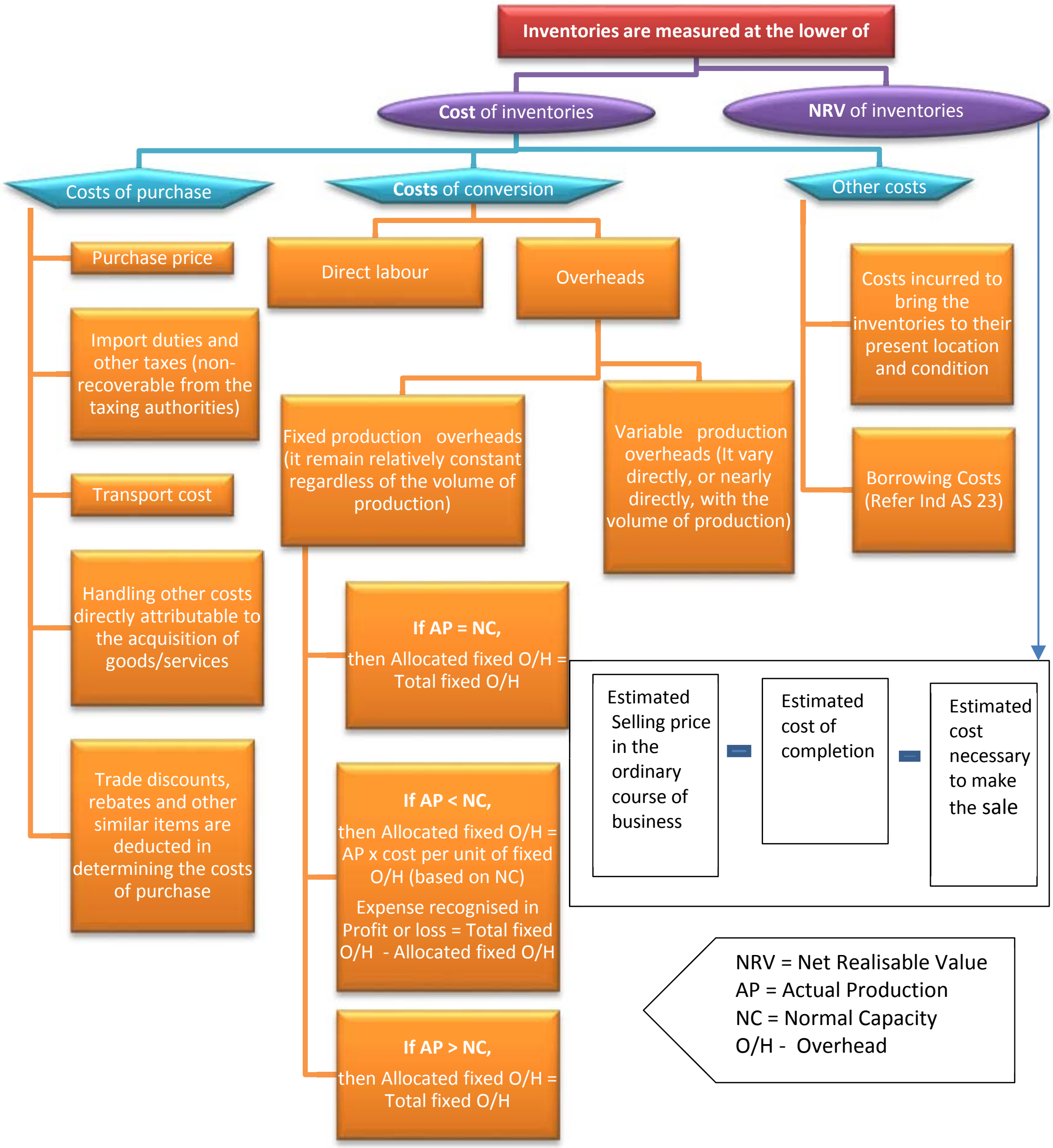


Illustration 2: Cost of Inventory

Venus Trading Company purchases cars from several countries and sells them to Asian countries. During the current year, this company has incurred following expenses:

1. *Trade discounts on purchase*
2. *Handling costs relating to imports*

3. Salaries of accounting department

4. Sales commission paid to sales agents

5. After sales warranty costs

6. Import duties

7. Costs of purchases (based on supplier's invoices)

8. Freight expense

9. Insurance of purchases

10. Brokerage commission paid to indenting agents

Evaluate which costs are allowed by Ind AS 2 for inclusion in the cost of inventory in the books of Venus.

Solution

Items number 1, 2, 6, 7, 8, 9, 10 are allowed by Ind AS 2 for the calculation of cost of inventories. Salaries of accounts department, sales commission, and after sale warranty costs are not considered to be the cost of inventory. Therefore, they are not allowed by Ind AS 2 for inclusion in cost of inventory and are expensed off in the profit and loss account.

*****

Illustration 3

As per Ind AS 2, selling costs are excluded from the cost of inventories and are required to be recognised as an expense in the period in which these are incurred. Whether the distribution costs would now be included in the cost of inventories under Ind AS 2.

Solution

Selling and distribution costs are generally used as single term because both are related, as selling costs are incurred to effect the sale and the distribution costs are incurred by the seller to complete a sale transaction by making the goods available to the buyer from the point of sale to the point at which the buyer takes possession. Since these costs are not related to bringing the goods to their present location and condition, the same are not included in the cost of inventories. Accordingly, though the word 'distribution costs' is not specifically mentioned in Ind AS 2, these costs would continue to be excluded from the cost of inventories.

*****

5) Allocation of cost to joint products and by-products

- A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product.

- When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production.
- Most by-products, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

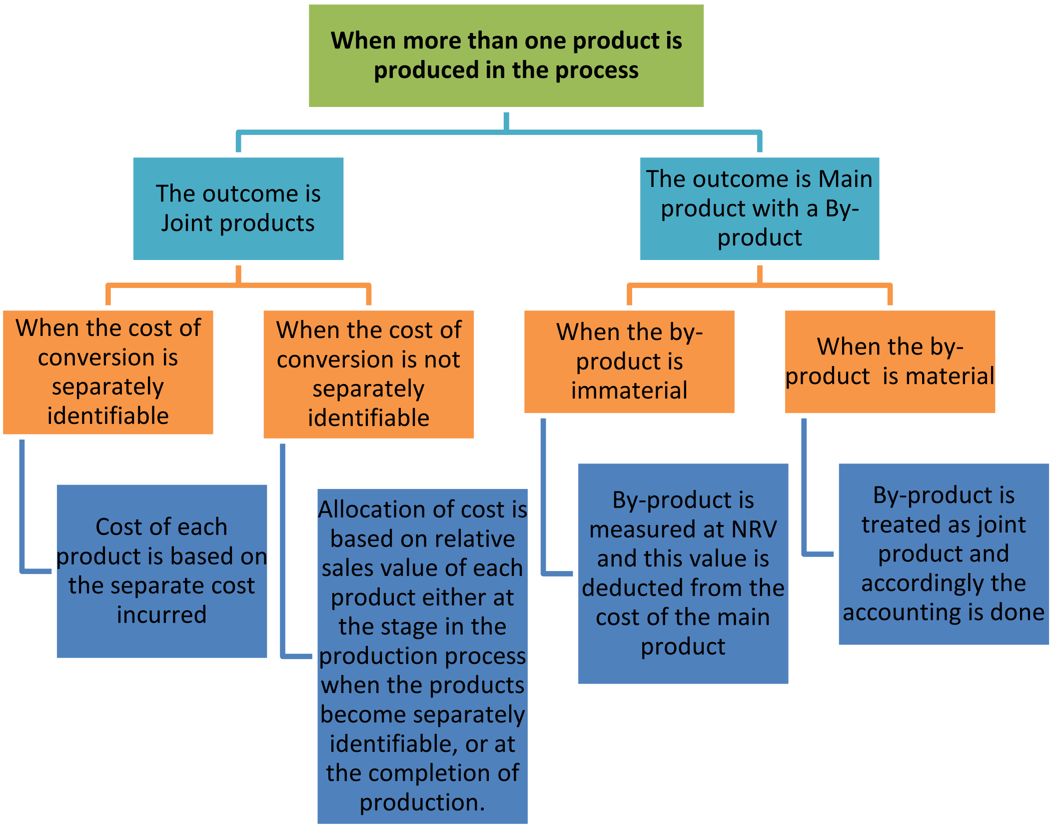


Illustration 4

In a manufacturing process of Mars ltd, one by-product BP emerges besides two main products MP1 and MP2 apart from scrap. Details of cost of production process are here under:

Item	*Unit*	*Amount*	*Output*	*Closing Stock 31-3-20X1*
Raw material	14,500	1,50, 000	MP 1-5,000 units	250

Wages	-	90,000	MP II - 4,000 units	100
Fixed overhead	-	65,000	BP- 2,000 units	
Variable overhead	-	50,000		

Average market price of MP1 and MP2 is ₹ 60 per unit and ₹ 50 per unit respectively, by- product is sold @ ₹ 20 per unit. There is a profit of ₹ 5,000 on sale of by-product after incurring separate processing charges of ₹ 8,000 and packing charges of ₹ 2,000, ₹ 5,000 was realised from sale of scrap.

Required:

Calculate the value of closing stock of MP1 and MP2 as on 31-03-20X1.

Solution

As per Ind AS 2 'Inventories', most by-products as well as scrap or waste materials, by their nature, are immaterial. They are often measured at net realizable value and this value is deducted from the cost of the main product.

1) Calculation of NRV of By-product BP

Selling price of by-product	2,000 units x 20 per unit	40,000
Less: Separate processing charges of by- product BP		(8,000)
Packing charges		(2,000)
Net realizable value of by-product BP		**30,000**

2) Calculation of cost of conversion for allocation between joint products MP1 and MP2

Raw material		1,50,000
Wages		90,000
Fixed overhead		65,000
Variable overhead		50,000
Less: NRV of by-product BP (See calculation 1)	30,000	
Sale value of scrap	5,000	(35,000)
Joint cost to be allocated between MP1 and MP2		**3,20,000**

3) Determination of "basis for allocation" and allocation of joint cost to MP1 and MP2

	MP I	MP 2
Output in units (a)	5,000	4,000
Sales price per unit (b)	60	50
Sales value (a x b)	3,00,000	2,00,000
Ratio of allocation	3	2
Joint cost of ₹ 3,20,000 allocated in the ratio of 3:2 (c)	1,92,000	1,28,000
Cost per unit [c/a]	**38.4**	**32**

4) Determination of value of closing stock of MP1 and MP2

Particulars	MP I	MP 2
Closing stock in units	250 units	100 units
Cost per unit	38.4	32
Value of closing stock	9,600	3,200

*****

5) Cost of agricultural produce harvested from biological assets

In accordance with Ind AS 41, *Agriculture*, inventories comprising agricultural produce that an entity has harvested from its biological assets are measured on initial recognition at their fair value less costs to sell at the point of harvest. This is the cost of the inventories at that date for application of this Standard.

6) Techniques for the measurement of cost

- Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate to actual cost.
- <u>Standard Cost Method:</u> Cost is based on normal levels of materials and supplies, labour efficiency and capacity utilisation. They are regularly reviewed and revised where necessary

Measurement techniques

- Retail method
- Standard Cost

- Retail Method: Cost is determined by reducing the sales value of the inventory by the appropriate percentage gross margin. The percentage used takes into consideration inventory that has been marked down to below its original selling price. This method is often used in the retail industry for measuring inventories of rapidly changing items that have similar margins.
- The percentage used takes into consideration inventory that has been marked down to below its original selling price. An average percentage for each retail department is often used.

Illustration 5 : Measurement techniques of Cost

Mars Fashions is a new luxury retail company located in Lajpat Nagar, New Delhi. Kindly advise the accountant of the company on the necessary accounting treatment for the following items:

(a) One of Company's product lines is beauty products, particularly cosmetics such as lipsticks, moisturizers and compact make-up kits. The company sells hundreds of different brands of these products. Each product is quite similar, is purchased at similar prices and has a short lifecycle before a new similar product is introduced. The point of sale and inventory system is not yet fully functioning in this department. The sales manager of the cosmetic department is unsure of the cost of each product but is confident of the selling price and has reliably informed you that the Company, on average, make a gross margin of 65% on each line.

(b) Mars Fashions also sells handbags. The Company manufactures their own handbags as they wish to be assured of the quality and craftsmanship which goes into each handbag. The handbags are manufactured in India in the head office factory which has made handbags for the last fifty years. Normally, Mars manufactures 100,000 handbags a year in their handbag division which uses 15% of the space and overheads of the head office factory. The division employs ten people and is seen as being an efficient division within the overall company.

In accordance with Ind AS 2, explain how the items referred to in a) and b) should be measured.

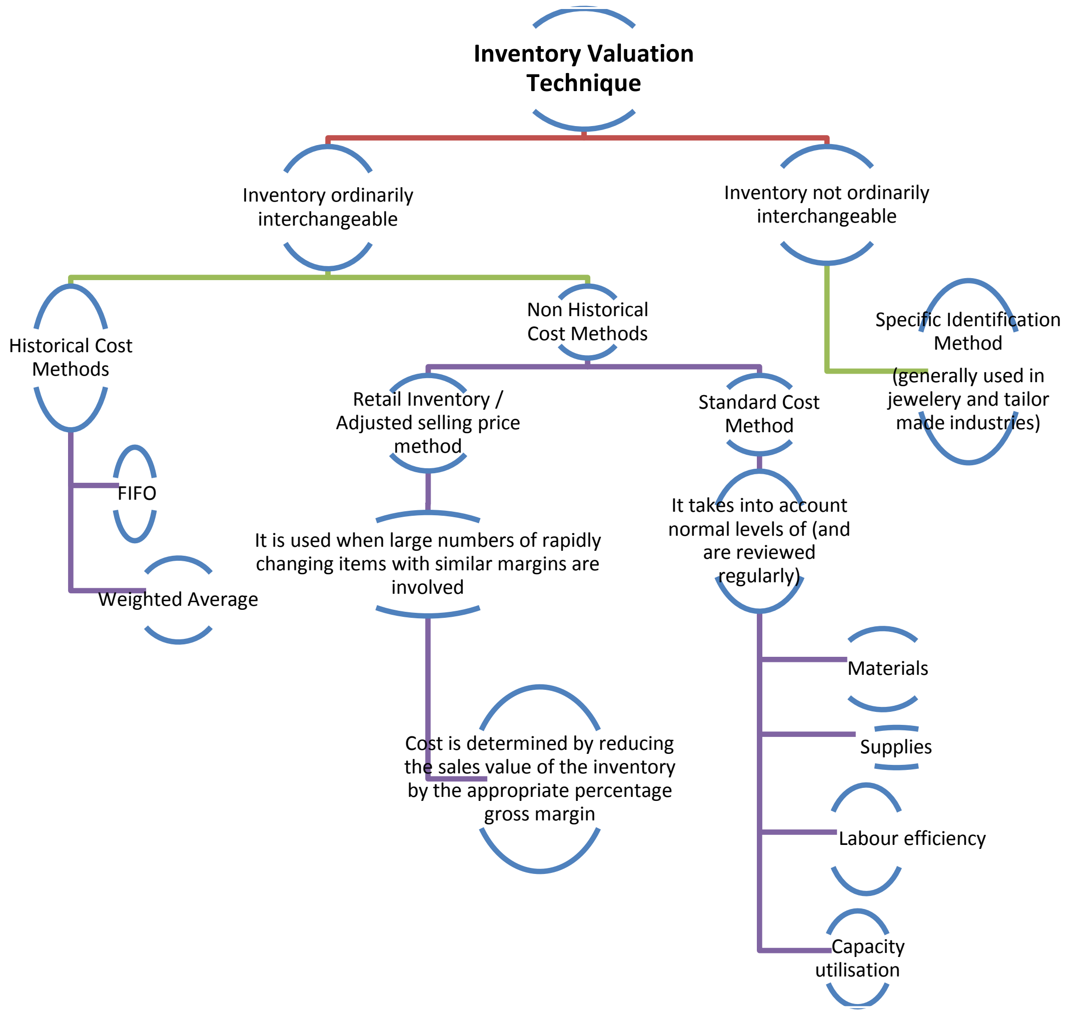
Solution

(a) The retail method can be used for measuring inventories of the beauty products. The cost of the inventory is determined by taking the selling price of the cosmetics and reducing it by the gross margin of 65% to arrive at the cost.

(b) The handbags can be measured using standard cost especially if the results approximate cost. Given that The company has the information reliably on hand in relation to direct materials, direct labour, direct expenses and overheads, it would be the best method to use to arrive at the cost of inventories.

*****

7) Cost Formulas



8) Inventory not ordinarily interchangeable

The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects shall be assigned by using specific identification of their individual costs. Specific identification of cost means that specific costs are attributed to identified items of inventory.

9) Inventory ordinarily interchangeable

- The costs of inventories, other than that are not ordinarily interchangeable and goods or services produced and segregated for specific projects, shall be assigned by using the first-in, first-out (FIFO) or weighted average cost formula.

- An entity shall use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formulas may be justified.

Illustration 6

Whether an entity can use different cost formulae for inventories held at different geographical locations having similar nature and use to it.

Solution

Paragraph 25 of Ind AS 2 prescribes that the cost of inventories, other than the items of inventories which are not ordinarily interchangeable as dealt with in paragraph 23, shall be assigned by using the first-in, first-out (FIFO) or weighted average cost formula. An entity shall use the same cost formula for all inventories having similar nature and use to it. In this case, since the inventories held at different geographical location are of similar nature and use to the entity, different cost formula cannot be used for inventory valuation purposes.

- **FIFO formula** assumes that the items of inventory that were purchased or produced first are sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced.
- Under the **weighted average** cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances of the entity.

Specific identification of items of inventory	Other items of inventory
⇩	⇩
Identified actual costs	Apply either : First-in first - out Weighted Average

Illustration 7

Mercury Ltd. uses a periodic inventory system. The following information relates to 20X1-20X2.

Date	*Particular*	*Unit*	*Cost p.u.*	*Total Cost*
April	*Inventory*	*200*	*10*	*2,000*
May	*Purchases*	*50*	*11*	*550*
September	*Purchases*	*400*	*12*	*4,800*

February	*Purchases*	*350*	*14*	*4,900*
	Total	*1,000*		*12,250*

Physical inventory at 31.03.20X2 400 units. Calculate ending inventory value and cost of sales using:

(a) FIFO

(b) Weighted Average

Solution

FIFO inventory 31.03.20X2	350 @14 = 50 @ 12 =	4,900 600 5,500
Cost of Sales	12,250-5,500 =	6,750
Weighted average cost per item Weighted average inventory at 31.03.20X2 Cost of sales 20X1-20X2	12,250/1000 = 400 x 12.25 = 12,250-4,900 =	12.25 4,900 7,350

*****

10) Net realisable value

Measurement of net realisable value

- 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. The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined.

Illustration 8

Whether the following costs should be considered while determining the Net Realisable Value (NRV) of the inventories?

(a) Costs of completion of work-in-progress;

(b) Trade discounts expected to be allowed on sale; and

(c) Cash discounts expected to be allowed for prompt payment

Solution

Ind AS 2 defines Net Realisable Value as 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."

Costs of completion of work-in-progress are incurred to convert the work-inprogress into finished goods. Since these costs are in the nature of completion costs, in accordance with the above definition, the same should be deducted from the estimated selling price to determine the NRV of work-in- progress.

The Guidance Note on Terms Used in Financial Statements defines Trade Discount as "A reduction granted by a supplier from the list price of goods or services on business considerations other than for prompt payment".

Trade discount is allowed either expressly through an agreement or through prevalent commercial practices in the terms of the trade and the same is adjusted in arriving at the selling price. Accordingly, the trade discount expected to be allowed should be deducted to determine the estimated selling price.

The Guidance Note on Terms Used in Financial Statements defines Cash Discount as "A reduction granted by a supplier from the invoiced price in consideration of immediate payment or payment within a stipulated period."

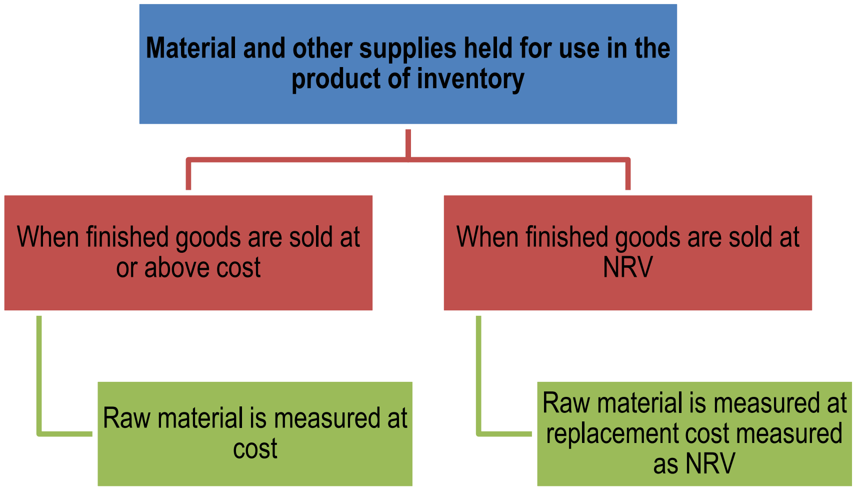
These type of costs are incurred to recover the sale proceeds immediately or before the end of the specified period or credit period allowed to the customer. In other words, these costs are not incurred to make the sale, therefore, the same should not be considered while determining NRV.

*****

- Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made, of the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the end of the period to the extent that such events confirm conditions existing at the end of the period.
- Estimates of net realisable value also take into consideration the purpose for which the inventory is held. For example, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess is based on general selling prices.
- Inventories are usually written down to net realisable value item by item. It is not appropriate to write inventories down on the basis of a classification of inventory, for example, finished goods, or all the inventories in a particular operating segment.

Writing inventories down to net realisable value

Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when a decline in the price of materials indicates that the cost of the finished products exceeds net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value.



Reversals of write-downs

- A new assessment is made of net realisable value in each subsequent period. When the circumstances that previously caused inventories to be written down below cost no longer exist or when there is clear evidence of an increase in net realisable value because of changed economic circumstances, the amount of the write-down is reversed (ie the reversal is limited to the amount of the original write-down) so that the new carrying amount is the lower of the cost and the revised net realisable value.
- This occurs, for example, when an item of inventory that is carried at net realisable value, because its selling price has declined, is still on hand in a subsequent period and its selling price has increased.

Illustration 9

Sun Pharma Limited, a renowned company in the field of pharmaceuticals has the following four items in inventory. The Cost and Net realizable value is given as follows:

Item	*Cost*	*Net Realisable Value*
A	*2,000*	*1,900*
B	*5,000*	*5,100*
C	*4,400*	*4,550*
D	*3,200*	*2,990*
Total	***14,600***	***14,540***

Determine the value of Inventories:

a. On an item by item basis

b. On a group basis

Solution

Inventories shall be measured at the lower of cost and net realisable value.

Item by item basis:	
A	1,900
B	5,000
C	4,400
D	2,990
	14,290
Group basis	**14,540**

*****

1.5 RECOGNITION AS AN EXPENSE

1) The amount of inventories recognised as an expense in the period will generally be:

   a) carrying amount of the inventories sold in the period in which related revenue is recognised; and

   b) the amount of any write-down of inventories to net realisable value and all losses of inventories shall be recognised as an expense in the period the write-down or loss occurs;

   reduced by

   the amount of any reversal in the period of any write-down of inventories, arising from an increase in net realisable value shall be recognized as a reduction in the amount of inventories recognised as an expense in the period in which the reversal occurs.

2) Some inventories may be allocated to other asset accounts, for example, inventory used as a component of self-constructed property, plant or equipment. Inventories allocated to another asset in this way are recognised as an expense during the useful life of that asset through charging of depreciation on that asset.

Example:

An item of inventory costing ₹ 20,000 as covered under Ind AS 2 is consumed in the construction of self-constructed property to be accounted as Property, plant and equipment under Ind AS 16. The cost of such property, plant and equipment other than inventories is ₹ 80,000. Such Inventory needs to be capitalized in the cost of Property, plant and equipment. The useful life of the property is 5 years. The depreciation on such property charged to profit and loss account is ₹ 20,000 per annum (i.e. 1,00,000/ 5)

1.6 DISCLOSURE

The financial statements shall disclose:

1) **Accounting policies**

   the accounting policies adopted in measuring inventories, including the cost formula used.

2) **Analysis of carrying amount**

   the total carrying amount of inventories and the carrying amount in classifications appropriate to the entity.

   Common classifications of inventories are as follows:

   a) Merchandise;

   b) Production supplies;

   c) Materials;

   d) Work in progress; and

   e) Finished goods.

   The inventories of a service provider may be described as work in progress

3) **Inventories carried at fair value less costs to sell**

   the carrying amount of inventories carried at fair value less costs to sell.

4) **Amounts recognised in profit or loss**

   a) the amount of inventories recognised as an expense during the period;

   b) the amount of any write-down of inventories recognised as an expense in the period; and

   c) the amount of any reversal of any write-down that is recognised as a reduction in the amount of inventories recognised as expense in the period.

      In addition, disclosure is required of the circumstances or events that led to the reversal of a write-down of inventories.

5) **Inventories pledged as security**

   the carrying amount of inventories pledged as security for liabilities.

An entity adopts a format for profit or loss that results in amounts being disclosed other than the cost of inventories recognised as an expense during the period. Under this format, the entity presents an analysis of expenses using a classification based on the nature of expenses. In this case, the entity discloses the costs recognised as an expense for raw materials and consumables, labour costs and other costs together with the amount of the net change in inventories for the period.

1.7 SIGNIFICANT DIFFERENCES IN IND AS 2 *VIS-À-VIS* AS 2

S. No.	Particular	Ind AS 2	AS 2
1.	*Subsequent Recognition*	Ind AS 2 deals with the subsequent recognition of cost/carrying amount of inventories as an expense	AS 2 does not provide the same
2.	*Inventory of Service Provider*	Ind AS 2 provides explanation with regard to inventories of service providers	AS 2 does not contain such an explanation
3.	*Machinery Spares*	Ind AS 2 does not contain specific explanation in respect of such spares as this aspect is covered under Ind AS 16	AS 2 explains that inventories do not include spare parts, servicing equipment and standby equipment which meet the definition of property, plant and equipment as per AS 10, Property, Plant and Equipment. Such items are accounted for in accordance with Accounting Standard (AS) 10, Property, Plant and Equipment.
4.	*Inventory held by Commodity Broker-traders*	Ind AS 2 does not apply to measurement of inventories held by commodity broker-traders, who measure their inventories at fair value less costs to sell.	This aspect is not there in the AS 2
5.	*Definition of Fair Value and Distinction Between NRV and Fair Value*	Ind AS 2 defines fair value and provides an explanation in respect of distinction between 'net realisable value' and 'fair value'	AS 2 does not contain the definition of fair value and such explanation.
6.	*Subsequent Assessment of NRV*	Ind AS 2 provides detailed guidance in case of subsequent assessment of net realisable value. It also deals with the reversal of the	AS 2 does not deal with such reversal.

		write-down of inventories to net realisable value to the extent of the amount of original write-down, and the recognition and disclosure thereof in the financial statements.	
7.	*Exclusion from its Scope but Guidance given*	Ind AS 2 excludes from its scope only the measurement of inventories held by producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products though it provides guidance on measurement of such inventories.	AS 2 excludes from its scope such types of inventories.
8.	*Cost Formulae*	Ind AS 2 requires the use of consistent cost formulas for all inventories having a similar nature and use to the entity.	AS 2 specifically provides that the formula used in determining the cost of an item of inventory should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition

TEST YOUR KNOWLEDGE

Questions

1. UA Ltd. purchased raw material @ ₹ 400 per kg. Company does not sell raw material but uses in production of finished goods. The finished goods in which raw material is used are expected to be sold at below cost. At the end of the accounting year, company is having 10,000 kg of raw material in inventory. As the company never sells the raw material, it does not know the selling price of raw material and hence cannot calculate the realizable value of the raw material for valuation of inventories at the end of the year. However, replacement cost of raw material is ₹ 300 per kg. How will you value the inventory of raw material?

2. Sun Ltd. has fabricated special equipment (solar power panel) during 20X1-20X2 as per drawing and design supplied by the customer. However, due to a liquidity crunch, the customer has requested the company for postponement in delivery schedule and requested the company to withhold the delivery of finished goods products and discontinue the production of balance items.

   As a result of the above, the details of customer balance and the goods held by the company as work-in-progress and finished goods as on 31-03-20X3 are as follows:

Solar power panel (WIP)	₹ 85 lakhs
Solar power panel (finished products)	₹ 55 lakhs
Sundry Debtor (solar power panel)	₹ 65 lakhs

   The petition for winding up against the customer has been filed during 20X2-20X3 by Sun Ltd. Comment with explanation on provision to be made of ₹ 205 lakh included in Sundry Debtors, Finished goods and work-in-progress in the financial statement of 20X2-20X3.

Answers

1. As per Ind AS 2 "Inventories", materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value. Therefore, in this case, UA Ltd. will value the inventory of raw material at ₹ 30,00,000 (10,000 kg. @ ₹ 300 per kg.).

2. From the fact given in the question it is obvious that Sun Ltd. is a manufacturer of solar power panel. As per Ind AS 2 'Inventories', inventories are assets (a) held for sale in the ordinary course of business; (b) in the process of production for such sale; or (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services. Therefore, solar power panel held in its stock will be considered as its inventory. Further, as per the standard, inventory at the end of the year are to be valued at lower of cost or NRV.

As the customer has postponed the delivery schedule due to liquidity crunch the entire cost incurred for solar power panel which were to be supplied has been shown in Inventory. The solar power panel are in the possession of the Company which can be sold in the market. Hence company should value such inventory as per principle laid down in Ind AS 2 i.e. lower of Cost or NRV. Though, the goods were produced as per specifications of buyer the Company should determine the NRV of these goods in the market and value the goods accordingly. Change in value of such solar power panel should be provided for in the books. In the absence of the NRV of WIP and Finished product given in the question, assuming that cost is lower, the company shall value its inventory as per Ind AS 2 for ₹ 140 lakhs [i.e solar power panel (WIP) ₹ 85 lakhs + solar power panel (finished products) ₹ 55 lakhs].

Alternatively, if it is assumed that there is no buyer for such fabricated solar power panel, then the NRV will be Nil. In such a case, full value of finished goods and WIP will be provided for in the books.

As regards Sundry Debtors balance, since the Company has filed a petition for winding up against the customer in 20X2-20X3, it is probable that amount is not recoverable from the party. Hence, the provision for doubtful debts for ₹ 65 lakhs shall be made in the books against the debtor's amount.

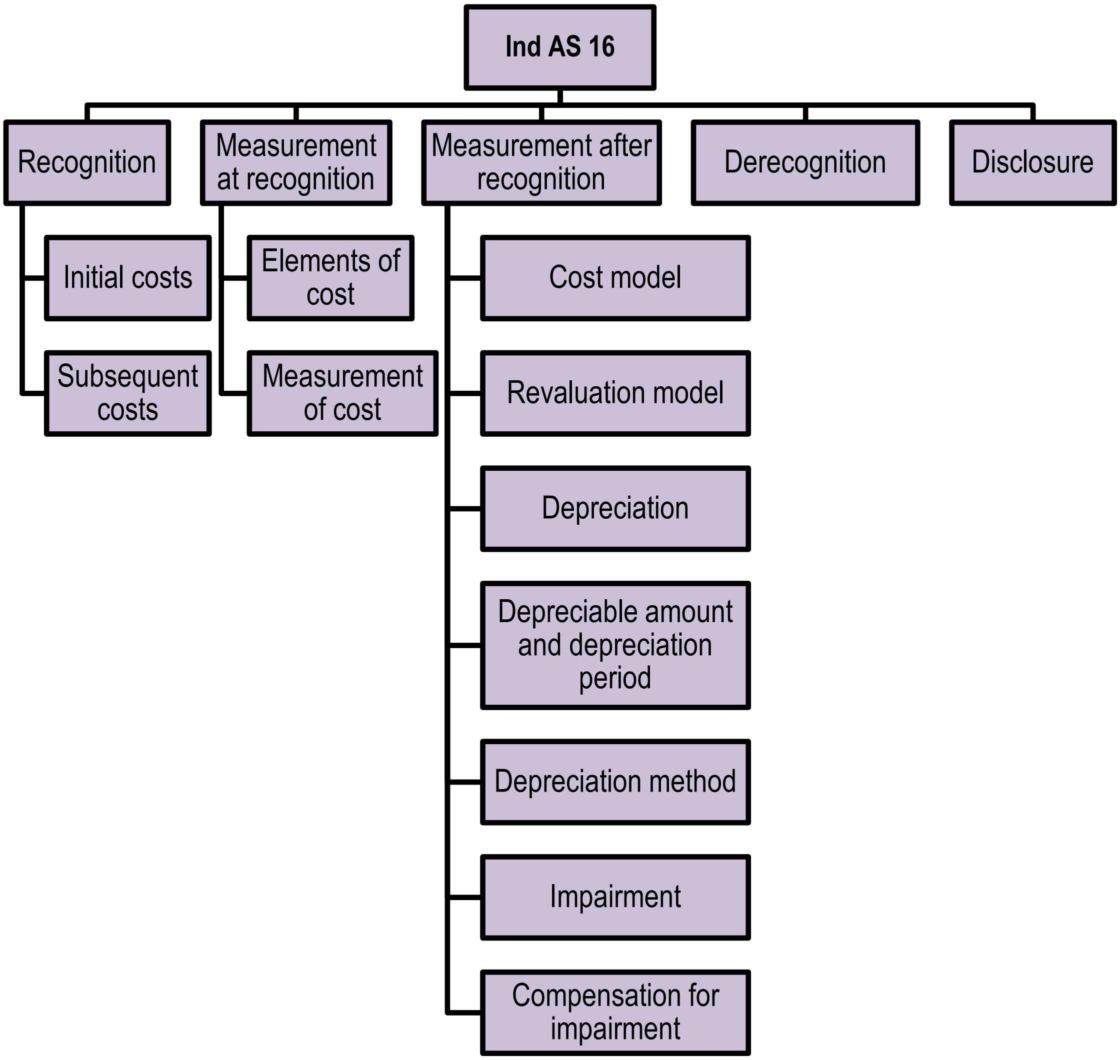
UNIT 2 : INDIAN ACCOUNTING STANDARD 16 : PROPERTY, PLANT AND EQUIPMENT

LEARNING OUTCOMES

After studying this unit, you will be able to

- Understand the objective and scope of this standard
- Define the terms Property, plant and equipment, bearer plant, entity-specific value, depreciable amount and useful life
- Deal with the Revaluation and cost models of accounting for property, plant and equipment.
- Differentiate between repairs and maintenance, replacement and major inspection
- Account for the changes in depreciation method, useful life and residual value
- Appreciate the accounting for changes in existing, decommissioning, restoration and similar assets

UNIT OVERVIEW



2.1 OBJECTIVE

The objective of this Standard is to prescribe the accounting treatment for property, plant and equipment. The principal issues in accounting for property, plant and equipment are the recognition of the assets, the determination of their carrying amounts and the depreciation charges and impairment losses to be recognised in relation to them.

Under Ind AS 16, property, plant and equipment is initially measured at its cost, subsequently measured using either a cost or a revaluation model and depreciated so that its depreciable amount is allocated on a systematic basis over its useful life.

2.2 SCOPE

- This Standard shall be applied in accounting for property, plant and equipment except when another Standard requires or permits a different accounting treatment.
- This Standard does not apply to:

(a) PPE classified as held for sale (as per Ind AS 105)	(b) Biological assets related to agricultural activity other than bearer plants (Ind AS 41)
(c) Recognition and measurement of exploration and evaluation assets (Ind AS 106)	(d) Mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources

- However, this Standard applies to property, plant and equipment used to develop or maintain the assets described in (b)–(d).
- An entity accounting for investment property in accordance with Ind AS 40, *Investment Property,* shall use the cost model in this Standard ***for owned investment property***.

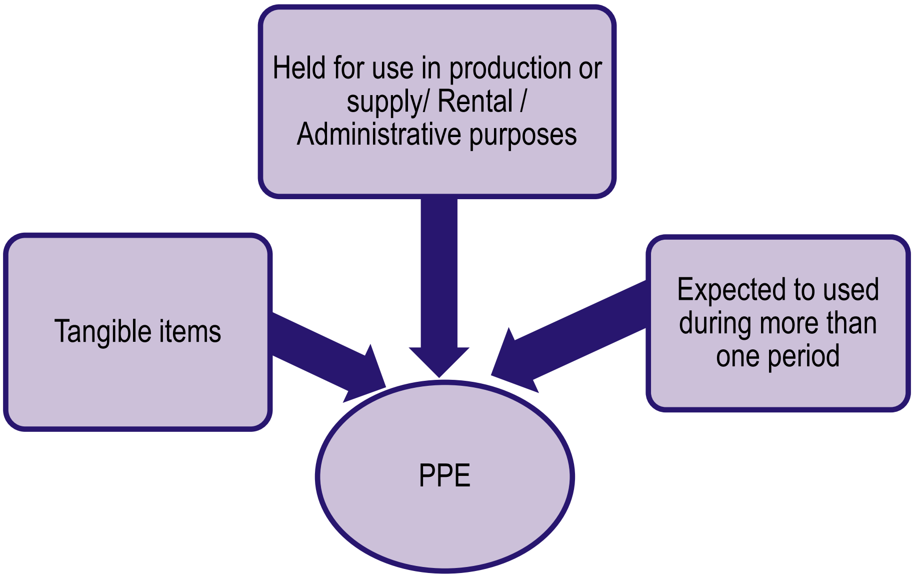
2.3 RELEVANT DEFINITIONS

The following are the key terms used in this standard:

- **Property, plant and equipment** are tangible items that:

a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

b) are expected to be used during more than one period.



- A **bearer plant** is a living plant that:

  (a) is used in the production or supply of agricultural produce;

  (b) is expected to bear produce for more than one period; and

  (c) has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.

- **Carrying amount** is the amount at which an asset is recognised after deducting any accumulated depreciation and accumulated impairment losses.

- **Cost** is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other Indian Accounting Standards, e.g. Ind AS 102, *Share-based Payment*.

- **Depreciable amount** is the cost of an asset, or other amount substituted for cost, less its residual value.

- **Depreciation** is the systematic allocation of the depreciable amount of an asset over its useful life.

- **Entity-specific value** is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability.
- **Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See Ind AS 113, *Fair Value Measurement*.)
- An **impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount.
- **Recoverable amount** is the higher of an asset's fair value less costs to sell and its value in use.
- The **residual value** of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.
- **Useful life** is:

  a) the period over which an asset is expected to be available for use by an entity; or

  b) the number of production or similar units expected to be obtained from the asset by an entity.

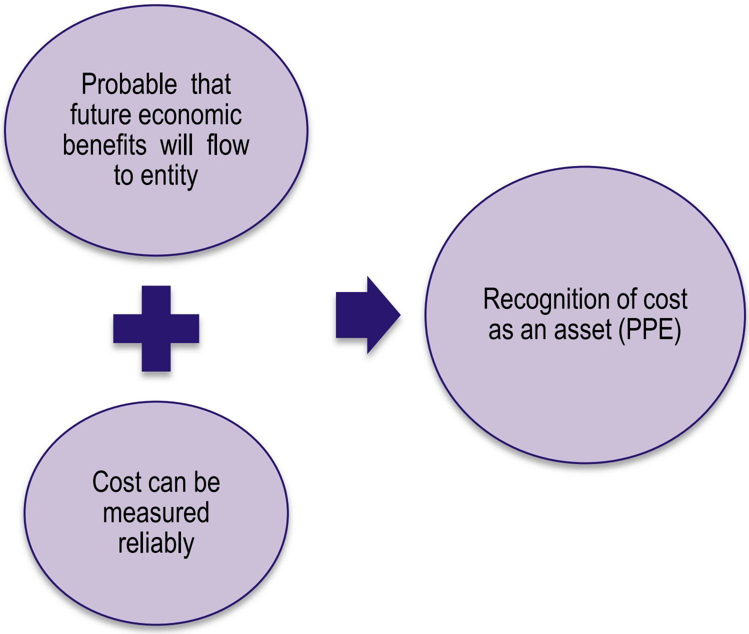
2.4 RECOGNITION

2.4.1 General recognition criteria

The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:

a) it is probable that future economic benefits associated with the item will flow to the entity; and

b) the cost of the item can be measured reliably.



2.4.2 Spare parts, stand-by equipment and servicing equipment

Items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with this Ind AS when they meet the definition of property, plant and equipment. Otherwise, such items are classified as inventory.

2.4.3 Aggregation of individually insignificant items

This Standard does not prescribe the unit of measure for recognition, ie what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances. It may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies, and to apply the criteria to the aggregate value.

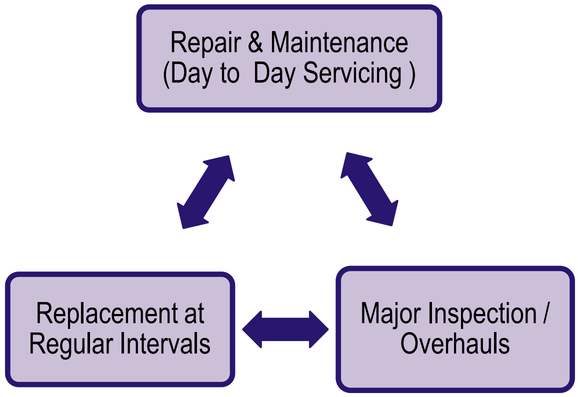
2.4.4 Initial Cost

Items of property, plant and equipment may be acquired for safety or environmental reasons. The acquisition of such property, plant and equipment, although not directly increasing the future economic benefits of any particular existing item of property, plant and equipment, may be necessary for an entity to obtain the future economic benefits from its other assets.

Such items of property, plant and equipment qualify for recognition as assets because they enable an entity to derive future economic benefits from related assets in excess of what could be derived had those items not been acquired.

For example: A chemical manufacturer may install new chemical handling processes to comply with environmental requirements for the production and storage of dangerous chemicals; related plant enhancements are recognised as an asset because without them the entity is unable to manufacture and sell chemicals. However, the resulting carrying amount of such an asset and related assets is reviewed for impairment in accordance with Ind AS 36 Impairment of Assets.

2.4.5 Subsequent costs



2.4.5.1 Repair and maintenance

An entity does not recognise in the carrying amount of an item of property, plant and equipment the costs of the day-to-day servicing of the item. Rather, these costs are recognised in profit or loss as incurred. Costs of day-to-day servicing are primarily the costs of labour and consumables, and may include the cost of small parts.

2.4.5.2 Replacement parts

- Parts of some items of property, plant and equipment may require replacement at regular intervals. For example, a furnace may require relining after a specified number of hours of use, or aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe.
- Items of property, plant and equipment may also be acquired to make a less frequently recurring replacement, such as replacing the interior walls of a building, or to make a non-recurring replacement.
- Under the recognition principle, an entity recognises in the carrying amount of an item of property, plant and equipment the cost of replacing part of such an item when that cost is incurred if the recognition criteria are met. The carrying amount of those parts that are replaced is derecognised in accordance with the derecognition provisions of this Standard.

2.4.5.3 Major inspections or overhauls

- A condition of continuing to operate an item of property, plant and equipment may be performing regular major inspections for faults regardless of whether parts of the item are replaced.

- When each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied.
- Any remaining carrying amount of the cost of the previous inspection is derecognised. This occurs regardless of whether the cost of the previous inspection was identified in the transaction in which the item was acquired or constructed. If necessary, the estimated cost of a future similar inspection may be used as an indication of what the cost of the existing inspection component was when the item was acquired or constructed.

Example - Inspection Cost

A shipping company is required by law to bring all ships into dry dock every five years for a major inspection and overhaul. Overhaul expenditure might at first sight seem to be a repair to the ships but it is actually a cost incurred in getting the ship back into a seaworthy condition. As such the costs must be capitalised.

A ship which cost ₹ 20 million with a 20 year life must have major overhaul every five years. The estimated cost of the overhaul at the five-year point is ₹ 5 million.

The depreciation charge for the first five years of the assets life will be as follows:

	Overhaul component (million)	Ship (other than overhaul component) (million)
Cost	5	15
Years	5	20
Depreciation per year	1	0.75

Total accumulated depreciation for the first five years will be ₹ 8.75, and the carrying amount of the ship at the end of year 5 will be ₹ 11.25 million.

The actual overhaul costs incurred at the end of year 5 are ₹ 6 million. This amount will now be capitalised into the costs of the ship, to give a carrying amount of ₹ 17.25 million.

The depreciation charge for years 6 to 10 will be as follows:

	Overhaul component	Ship (other than overhaul component)
Cost	6	11.25
Years	5	15
Depreciation per year	1.2	0.75

Annual depreciation for years 6 to 10 will now be ₹ 1.95 million. This process will be continued for years 11 to 15 and years 16 to 20. By the end of year 20, the capital cost of ₹ 20 million will have been depreciated plus the actual overhaul costs incurred at years 5, 10 and 15.

2.5 MEASUREMENT AT RECOGNITION

2.5.1 Measurement at cost

An item of property, plant and equipment that qualifies for recognition as an asset should be initially measured at its cost.

2.5.2 Element of cost

2.5.2.1 Cost of an acquired asset

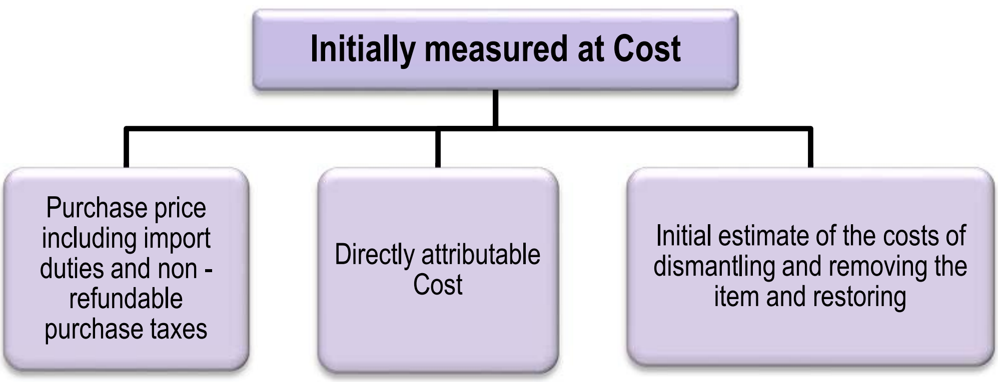
2.5.2.1.1 Component of cost

- The cost of an item of property, plant and equipment comprises:

  a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates;

  b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management; and

  c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.



2.5.2.2 Cost of self-constructed asset

The cost of a self-constructed asset is determined using the same principles as for an acquired asset. If an entity makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale.

- **Examples of directly attributable costs are:**

Employee benefits cost arising directly from construction or acquisition of PPE
Cost of Site Preparation
Initial delivery and handling costs
Installation and assembly costs
Professional Fees
Costs of testing - whether the asset is working properly after deducting proceeds from sale of any product produced during the testing period

- **Examples of costs that are not costs of an item of property, plant and equipment are:**

Costs of conducting business in a new location or with a new class of customer (including costs of staff training)	Costs incurred in introducing a new product or service	Cost of opening a new facility	Administrative and other general overhead costs

Therefore, any internal profits are eliminated in arriving at such costs. Similarly, the cost of abnormal amounts of wasted material, labour, or other resources incurred in self-constructing an asset is not included in the cost of the asset.

Ind AS 23, Borrowing Costs, establishes criteria for the recognition of interest as a component of the carrying amount of a self constructed item of property, plant and equipment.

Bearer plants are accounted for in the same way as self-constructed items of property, plant and equipment before they are in the location and condition necessary to be capable of operating in the manner intended by management. Consequently, references to 'construction' in this Standard should be read as covering activities that are necessary to cultivate the bearer plants before they are in the location and condition necessary to be capable of operating in the manner intended by management.

2.5.2.3 Cost of dismantling, removal and site restoration

Cost incurred by an entity in respect of obligation for dismantling, removing and restoring the site on which an item of property, plant and equipment is located are recognised and measured in accordance with Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets.

If the obligations are incurred when the asset is acquired, or during a period when the item is used other than to produce inventories, they are included in the cost of the item property, plant and equipment.

An entity applies Ind AS 2, Inventories, to the costs of obligations for dismantling, removing and restoring the site on which an item is located that are incurred during a particular period as a consequence of having used the item to produce inventories during that period.

2.5.2.4 Incidental operations

Some operations occur in connection with the construction or development of an item of property, plant and equipment, but are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management.

These incidental operations may occur before or during the construction or development activities. For example, income may be earned through using a building site as a car park until construction starts.

Because incidental operations are not necessary to bring an item to the location and condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are recognised in profit or loss and included in their respective classifications of income and expense.

2.5.2.5 Cessation of capitalisation

Recognition of costs in the carrying amount of an item of property, plant and equipment ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an item are not included in the carrying amount of that item.

- **For example, the following costs are not included in the carrying amount of an item of property, plant and equipment:**

  a) costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity;

  b) initial operating losses, such as those incurred while demand for the item's output builds up; and

  c) costs of relocating or reorganising part or all of an entity's operations.

Example

Moon Ltd incurs the following costs in relation to the construction of a new factory and the introduction of its products to the local market.

Particulars	***₹ 000 (cost incurred)***	***₹ 000 (As per Ind AS 16)***
Site preparation costs	150	150
Direct Material	2,000	2,000
Direct Labour cost, including ₹ 10,000 incurred during an industrial strike	1,160	1,150
Testing of various processes in factory	200	200
Consultancy fees for installation of equipment	300	300
Relocation of staff to new factory	450	-
General overheads	550	-
Estimated Costs to dismantle (at present value)	200	200
Total Cost to be Capitalised as per Ind AS 16		**4,000**

2.5.3 Measurement of cost

2.5.3.1 Payment deferred beyond normal credit terms

The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognised as interest over the period of credit unless such interest is capitalised in accordance with Ind AS 23.

Illustration 1 - Deferred Payment Credit

On 1st April, 20X1, an item of property is offered for sale at ₹ 10 million, with payment terms being three equal installments of ₹ 33,33,333 over a two-year period (payments are made on 1st April, 20X1, 31st March, 20X2 and 31st March, 20X3). Implicit interest rate of 5.36 percent p.a.

Show how the property will be recorded in accordance of Ind AS 16.

Solution:

Ind AS 16 requires that the cost of an item of PPE is the cash price equivalent at the recognition date. Hence, the purchaser that takes up the deferred payment terms will recognise the acquisition of the asset as follows:

		(₹)	(₹)
On 1st April, 20X1			
Property, Plant and Equipment (W.N. 1)	Dr.	95,00,000	
To Bank A/c			33,33,333
To Accounts Payable (W.N. 2)			61,66,667
(Initial recognition of property)			
On 31st March, 20X2			
Interest Expense (W.N. 2)	Dr.	3,30,533	
Accounts payable (W.N. 2)	Dr.	30,02,800	
To Bank A/c			33,33,333
(Recognition of interest expense and payment of second installment)			
On 31st March, 20X3			
Interest Expense (W.N. 2)	Dr.	1,69,467	
Accounts payable (W.N. 2)	Dr.	31,63,867	
To Bank A/c			33,33,334
(Recognition of interest expense and payment of final installment)			

Working Notes:

1. Calculation of cash price equivalent at initial recognition

Year	Payment	Discounting factor	Present value
1.4.20X1	33,33,333	1.000	33,33,333
31.3.20X2	33,33,333	0.949	31,63,333
31.3.20X3	33,33,334	0.901	30,03,333
Initial date cash price equivalent	1,00,00,000		95,00,000

2. Calculation of interest expenses

Year	Opening balance (a)	Interest @ 5.36% (b) = (a) x 5.36%	Total payment at year beginning (c)	Principal amount in the instalment (d) = (c) – (b)	Closing balance (e) = (a) - (d)
1.4.20X1	95,00,000	-	33,33,333	33,33,333	61,66,667
31.3.20X2	61,66,667	3,30,533	33,33,333	30,02,800	31,63,867
31.3.20X3	31,63,867	1,69,467*	33,33,334	31,63,867	Nil

*Difference of Rs. 116 [(31,63,867 x 5.36%) – (33,33,334 - 31,63,867)] is due to approximation.

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2.5.3.2 Exchange of assets

- One or more items of property, plant and equipment may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and nonmonetary assets. The cost of such an item of property, plant and equipment is measured at fair value (even if an entity cannot immediately derecognise the asset given up) unless:

  a) the exchange transaction lacks commercial substance; or

  b) the fair value of neither the asset received nor the asset given up is reliably measurable.

- If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

- An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

  a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or

  b) the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange; and

  c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

- For the purpose of determining whether an exchange transaction has commercial substance, the entity-specific value of the portion of the entity's operations affected by the transaction shall reflect post-tax cash flows.

- The fair value of an asset is reliably measurable if:

  a) the variability in the range of reasonable fair value measurements is not significant for that asset or

  b) the probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value.

- If an entity is able to measure reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure the cost of the asset received unless the fair value of the asset received is more clearly evident.

- The carrying amount of an item of property, plant and equipment may be reduced by Government grants in accordance with Ind AS 20, Accounting for Government Grants and Disclosure of Government Assistance.

If PPE is acquired in exchange for other non monetary asset or for a combination of monetary and non monetary asset

↓

Measure cost at fair value	
Unless the exchange transaction has no commercial substance or	Fair value of neither the asset received nor given up can be measured relaibly

Illustration 2 – Exchange of Assets

Pluto Ltd owns land and building which are carried in its balance sheet at an aggregate carrying amount of ₹ 10 million. The fair value of such asset is ₹ 15 million. It exchanges the land and building for a private jet, which has a fair value of ₹ 20 million, and pays additional ₹ 3 million in cash.

Show the necessary treatment as per Ind AS 16.

Solution

Provided that the transaction has commercial substance, the entity should recognised the private jet at a cost of ₹ 18 million (its fair value) and should recognise a profit on disposal of the land and building of ₹ 5 million, calculated as follow:

	(₹ 000)
Recognition of fair value of asset acquired (15,000 + 3,000)	18,000
Less: Carrying amount of land and building disposed	(10,000)
Cash Paid	(3,000)
Profit on exchange of assets	5,000

The required journal entry is therefore as follow:

Property, Plant and Equipment (Private Jet) Dr.	18,000	
To Property, Plant and Equipment (Land and Building)		10,000
To Cash		3,000
To Profit on exchange of assets		5,000

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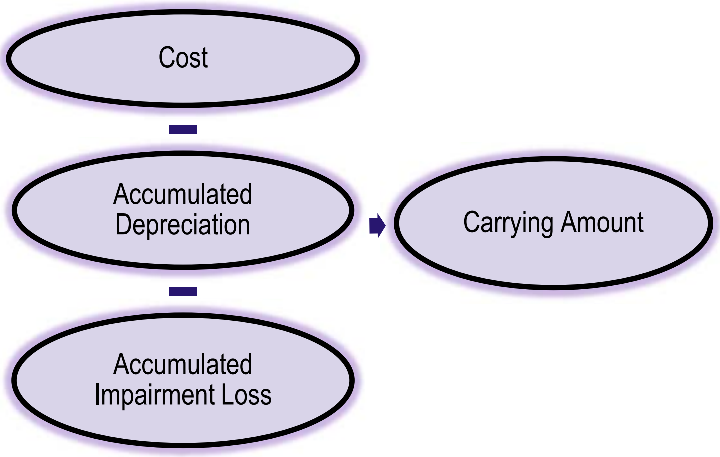
2.6 MEASUREMENT AFTER RECOGNITION

2.6.1 Alternative bases available for measurement after recognition

An entity may choose either the cost model or the revaluation model as its accounting policy and should apply that policy to an entire class of property, plant and equipment.

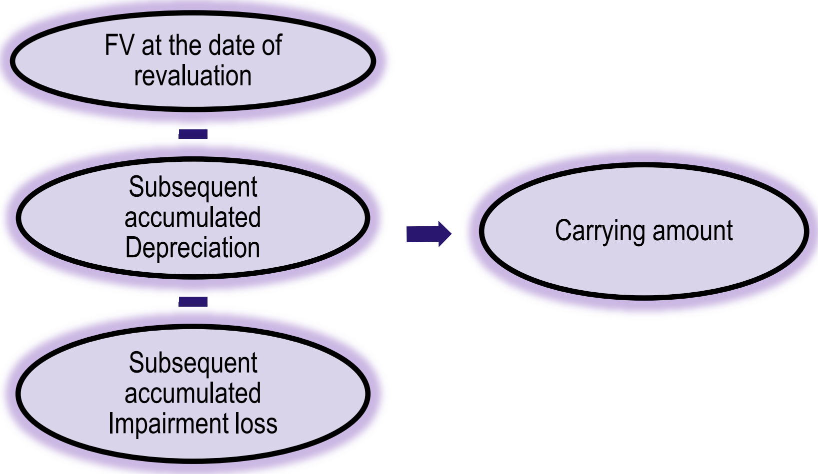
2.6.2 Cost model

After recognition as an asset, an item of property, plant and equipment should be carried at its cost less any accumulated depreciation and any accumulated impairment losses.



2.6.3 Revaluation model

After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably is carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations are required to be carried out with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.



2.6.3.1 Frequency of revaluations

- The frequency of revaluations depends upon the changes in fair values of the items of property, plant and equipment being revalued. When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is required. Some items of property, plant and equipment experience significant and volatile changes in fair value, thus necessitating annual revaluation.
- Such frequent revaluations are unnecessary for items of property, plant and equipment with only insignificant changes in fair value. Instead, it may be necessary to revalue the item only every three or five years.

2.6.3.2 Accumulated depreciation at the date of revaluation

- When an item of property, plant and equipment is revalued, the carrying amount of that asset is adjusted to the revalued amount. At the date of the revaluation, the asset is treated in one of the following ways:

  a) the gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. For example, the gross carrying amount may be restated by reference to observable market data or it may be restated proportionately to the change in the carrying amount. The accumulated depreciation at the date of the revaluation is adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses; or

  b) the accumulated depreciation is eliminated against the gross carrying amount of the asset.

Illustration 3: Accumulated depreciation at the date of revaluation

Jupiter Ltd. has an item of property, plant and equipment with an initial cost of ₹ 100,000. At the date of revaluation accumulated depreciation amounted to ₹ 55,000. The fair value of asset, by reference to transactions in similar assets, is assessed to be ₹ 65,000.

Find out the entries to be passed?

Solution

Method – I:

Accumulated depreciation	Dr.	55,000	
To Asset Cost			55,000
Asset Cost	Dr.	20,000	
To Revaluation reserve			20,000

The net result is that the asset has a carrying amount of ₹ 65,000 (100,000 – 55,000 + 20,000).

Method – II:

Carrying amount (100,000 – 55,000) =	45,000
Fair value (revalued amount)	65,000
Surplus	20,000
% of surplus (20,000 / 45,000)	44.44%

Entries to be Made:

Asset (1,00,000 x 44.44%)	Dr.	44,444	
To Accumulated Depreciation (55,000 x 44.44%)			24,444
To Surplus on Revaluation			20,000

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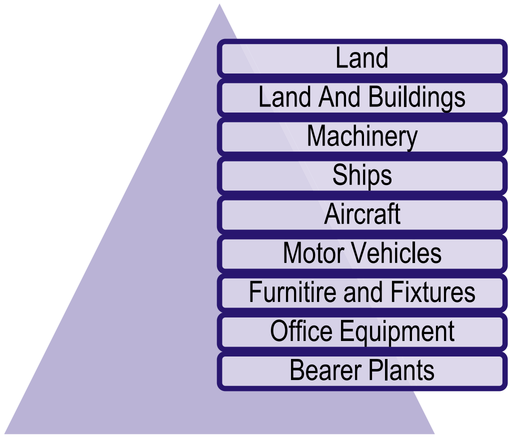
2.6.3.3 Revaluation to be made for entire class of assets

If an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued.

A class of property, plant and equipment is a grouping of assets of a similar nature and use in an entity's operations. The following are examples of separate classes:



The items within a class of property, plant and equipment are revalued simultaneously to avoid selective revaluation of assets and the reporting of amounts in the financial statements that are a mixture of costs and values as at different dates.

However, a class of assets may be revalued on a rolling basis provided revaluation of the class of assets is completed within a short period and provided the revaluations are kept up to date.

Illustration 4: Revaluation model for entire class

Venus Ltd. is a large manufacturing group. It owns a considerable number of industrial buildings, such as factories and warehouses, and office buildings in several capital cities. The industrial buildings are located in industrial zones whereas the office buildings are in central business districts of the cities. Venus's Ltd. management wants to apply the Ind AS 16 revaluation model to subsequent measurement of the office buildings but continue to apply the historical cost model to the industrial buildings. Is this acceptable under Ind AS 16, Property, Plant and Equipment?

Solution

Venus's Ltd. management can apply the revaluation model only to the office buildings.

The office buildings can be clearly distinguished from the industrial buildings in terms of their function, their nature and their general location.

Ind AS 16 permits assets to be revalued on a class-by-class basis.

The different characteristics of the buildings enable them to be classified as different PPE classes. The different measurement models can therefore be applied to these classes for subsequent measurement. All properties within the class of office buildings must therefore be carried at revalued amount. Separate disclosure of the two classes must be given in accordance with para 73 of Ind AS 16.

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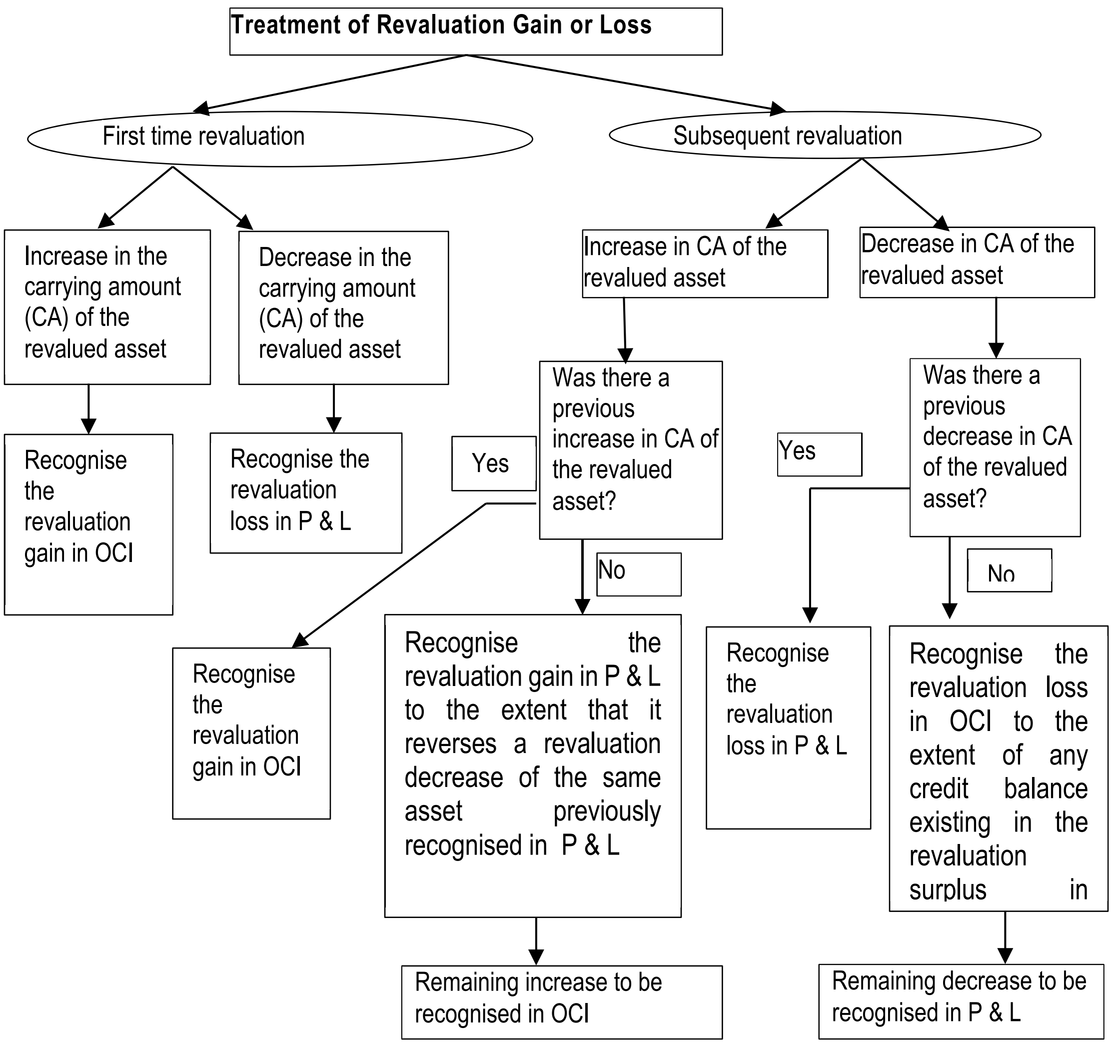
2.6.3.4 Treatment of surplus or deficit arising on revaluation

- If an asset's carrying amount is increased as a result of a revaluation, the increase should be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, the increase should be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.
- If an asset's carrying amount is decreased as a result of a revaluation, the decrease should be recognised in profit or loss. However, the decrease should be recognised in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. The decrease recognised in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.

Treatment of revaluation gain and loss is summarized in the below diagram :



The revaluation surplus included in equity in respect of an item of property, plant and equipment may be transferred directly to retained earnings when the asset is derecognised. This may involve transferring the whole of the surplus when the asset is retired or disposed of.

However, some of the surplus may be transferred as the asset is used by an entity. In such a case, the amount of the surplus transferred would be the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on the asset's original cost. Transfers from revaluation surplus to retained earnings are not made through profit or loss.

The effects of taxes on income, if any, resulting from the revaluation of property, plant and equipment are recognised and disclosed in accordance with Ind AS 12, *Income Taxes*.

Illustration 5: Utilisation of Revaluation Surplus

An item of PPE was purchased for ₹ 9,00,000 on 1st April, 20X1. It is estimated to have a useful life of 10 years and is depreciated on a straight line basis. On 1st April, 20X3, the asset is revalued to ₹ 9,60,000. The useful life remains unchanged as ten years. Ignore impact of deferred taxes.

Show the necessary treatment as per Ind AS 16.

Solution

Calculation of Additional Depreciation:	**(₹)**
Actual depreciation for 20X3-20X4 based on revalued amount (9,60,000/8)	1,20,000
Depreciation for 20X3-20X4 based on historical cost (9,00,000/10)	(90,000)
Additional Depreciation	30,000

In the profit or loss for 20X3-20X4, a depreciation expense of ₹ 1,20,000 will be charged. A reserve transfer, which will be shown in the statement of changes in equity, may be undertaken as follows:

Revaluation surplus	Dr.	30,000	
To Retained earnings			30,000

The closing balance on the revaluation surplus on 31st March, 20X4 will therefore be as follows:

Balance arising on revaluation (9,60,000 – 7,20,000)		240,000
Transfer to retained earnings		(30,000)
		210,000

2.6.4 Depreciation

- The depreciable amount of an asset should be allocated on a systematic basis over its useful life. The depreciation charge for each period should be recognised in profit or loss unless it is included in the carrying amount of another asset.

- Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item should be depreciated separately.
- An entity allocates the amount initially recognised in respect of an item of property, plant and equipment to its significant parts and depreciates separately each such part.
- A significant part of an item of property, plant and equipment may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item. Such parts may be grouped in determining the depreciation charge.
- To the extent that an entity depreciates separately some parts of an item of property, plant and equipment, it also depreciates separately the remainder of the item. The remainder consists of the parts of the item that are individually not significant. If an entity has varying expectations for these parts, approximation techniques may be necessary to depreciate the remainder in a manner that faithfully represents the consumption pattern and/or useful life of its parts.
- Land and buildings are separable assets and are accounted for separately, even when they are acquired together. With some exceptions, such as quarries and sites used for landfill, land has an unlimited useful life and therefore is not depreciated. Buildings have a limited useful life and therefore are depreciable assets. An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building.
- If the cost of land includes the costs of site dismantlement, removal and restoration, that portion of the land asset is depreciated over the period of benefits obtained by incurring those costs. In some cases, the land itself may have a limited useful life, in which case it is depreciated in a manner that reflects the benefits to be derived from it.

2.6.4.1 Residual Value

The residual value and the useful life of an asset should be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) should be accounted for as a change in an accounting estimate in accordance with Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*.

Illustration 6: Revision of Useful Life

An asset which cost ₹ 10,000 was estimated to have a useful life of 10 years and residual value ₹ 2000. After two years, useful life was revised to 4 remaining years.

Calculate the depreciation charge.

Solution: ₹

	Year-1	Year-2	Year-3
Cost	10,000	10,000	10,000

Less: Accumulated Depreciation	(800)	(1,600)	(3,200)
Carrying Amount	9,200	8,400	6,800
Charges for year	$\frac{10{,}000 - 2{,}000}{10} = 800$	$\frac{10{,}000 - 2{,}000}{10} = 800$	$\frac{8{,}400 - 2{,}000}{4} = 1{,}600$

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- The residual value of an asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the asset's depreciation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount.
- Depreciation is recognised even if the fair value of the asset exceeds its carrying amount, as long as the asset's residual value does not exceed its carrying amount. Repair and maintenance of an asset do not negate the need to depreciate it.

2.6.4.2 Commencement of depreciation

Depreciation of an asset begins when it is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

2.6.4.3 Cessation of depreciation

- Depreciation of an asset ceases at the earlier of:
  a) the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with Ind AS 105.
  b) and the date that the asset is derecognised.
- Therefore, depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production.

2.6.4.4 Factors affecting the useful life of an asset

The future economic benefits embodied in an asset are consumed by an entity principally through its use. However, other factors, such as technical or commercial obsolescence and wear and tear while an asset remains idle, often result in the diminution of the economic benefits that might have been obtained from the asset. Consequently, all the following factors are considered in determining the useful life of an asset:

a) expected usage of the asset. Usage is assessed by reference to the asset's expected capacity or physical output;

b) expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle;

c) technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset. Expected future reductions in the selling price of an item that was produced using an asset could indicate the expectation of technical or commercial obsolescence of the asset, which, in turn, might reflect a reduction of the future economic benefits embodied in the asset; and

d) legal or similar limits on the use of the asset, such as the expiry dates of related leases.

2.6.4.5 Impact of an entity's asset management policy

The useful life of an asset is defined in terms of the asset's expected utility to the entity. The asset management policy of the entity may involve the disposal of assets after a specified time or after consumption of a specified proportion of the future economic benefits embodied in the asset.

Therefore, the useful life of an asset may be shorter than its economic life. The estimation of the useful life of the asset is a matter of judgement based on the experience of the entity with similar assets.

2.6.4.6 Depreciation method

The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

The depreciation method applied to an asset is reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method should be changed to reflect the changed pattern. Such a change is accounted for as a change in an accounting estimate in accordance with Ind AS 8.

Illustration 7: Change in Depreciation Method

An entity acquired an asset 3 years ago at a cost of ₹ 5 million. The depreciation method adopted for the asset was 10 percent reducing balance method.

At the end of Year 3, the entity estimates that the remaining useful life of the asset is 8 years and determines to adopt straight –line method from that date so as to reflect the revised estimated pattern of recovery of economic benefits.

Show the necessary treatment in accordance of Ind AS 16.

Solution

Change in Depreciation Method shall be accounted for as a change in an accounting estimate in accordance of Ind AS 8 and hence will have a prospective effect.

Depreciation Charges for year 1 to 11 will be as follows:

Year 1	₹ 500,000
Year 2	₹ 450,000
Year 3	₹ 405,000
Year 4 to Year 11 (refer W.N.)	₹ 455,625 p.a.

Working Note:

Year	Opening balance of asset (a)	Depreciation @ 10% on (a)	Closing balance of asset (c) = (a)- (b)
1	50,00,000	5,00,000	45,00,000
2	45,00,000	4,50,000	40,50,000
3	40,50,000	4,05,000	36,45,000

Year 3 onwards method of depreciation has been changed from reducing balance method to straight line method for which it is assessed that the remaining useful life is 8 years. Hence revised depreciation would be calculated as follows:

Revised depreciation as per straight line method = (Carrying amount as at the end of the 3rd year – Residual value) / Remaining useful life

= 36,45,000/8 years = Rs.4,55,625 per annum (for year 4 to year 11).

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A variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include:

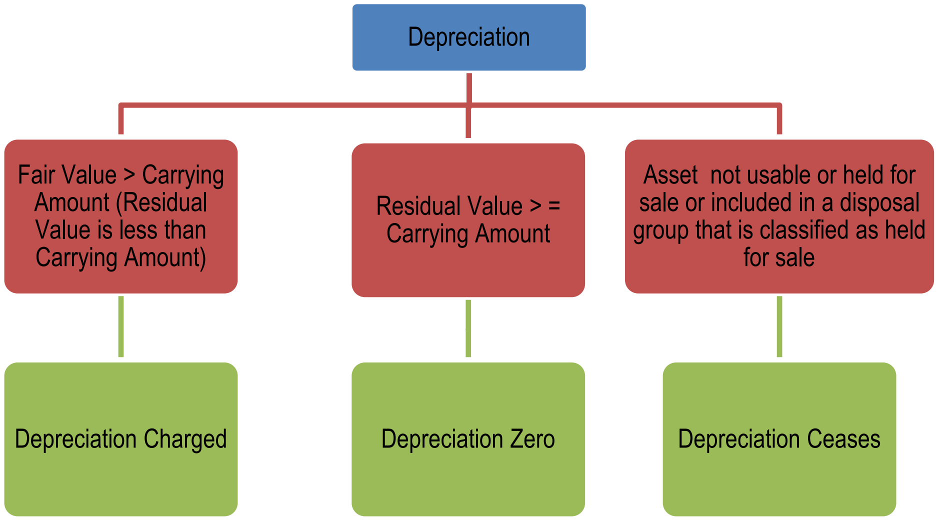
a) Straight-line depreciation method results in a constant charge over the useful life if the asset's residual value does not change.

b) Diminishing balance method results in a decreasing charge over the useful life.

c) Units of production method results in a charge based on the expected use or output.

The entity selects the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. That method is applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits.

A depreciation method that is based on revenue that is generated by an activity that includes the use of an asset is not appropriate. The revenue generated by an activity that includes the use of an asset generally reflects factors other than the consumption of the economic benefits of the asset (e.g. other inputs and processes, selling activities and changes in sales volumes and prices).



2.6.5 Impairment

2.6.5.1 Identification of an impairment loss

To determine whether an item of property, plant and equipment is impaired, an entity applies Ind AS 36, *Impairment of Assets*. Ind AS 36 explains how an entity reviews the carrying amount of its assets, how it determines the recoverable amount of an asset, and when it recognises, or reverses the recognition of, an impairment loss.

2.6.5.2 Compensation for impairment

- Compensation from third parties for items of property, plant and equipment that were impaired, lost or given up shall be included in profit or loss when the compensation becomes receivable.
- Impairments or losses of items of property, plant and equipment, related claims for or payments of compensation from third parties and any subsequent purchase or construction of replacement assets are separate economic events and are accounted for separately as follows:

  a) impairments of items of property, plant and equipment are recognised in accordance with Ind AS 36;

  b) derecognition of items of property, plant and equipment retired or disposed of is determined in accordance with this Standard;

  c) compensation from third parties for items of property, plant and equipment that were impaired, lost or given up is included in determining profit or loss when it becomes receivable; and

  d) the cost of items of property, plant and equipment restored, purchased or constructed as replacements is determined in accordance with this Standard.

2.7 DERECOGNITION

2.7.1 Derecognition- general

- The carrying amount of an item of property, plant and equipment should be derecognised:
  a) on disposal; or
  b) when no future economic benefits are expected from its use or disposal.
- The gain or loss arising from the derecognition of an item of property, plant and equipment is included in profit or loss when the item is derecognised (unless Ind AS 116 requires otherwise on a sale and leaseback). Gains shall not be classified as revenue.
- The gain or loss arising from the derecognition of an item of property, plant and equipment shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the item.
- The date of disposal of an item of property, plant and equipment is the date the recipient obtains control of that item in accordance with the requirements for determining when a performance obligation is satisfied in Ind AS 115. ***Ind AS 116 applies to disposal by a sale and leaseback.***
- The amount of consideration to be included in the gain or loss arising from the derecognition of an item of property, plant and equipment is determined in accordance with the requirements for determining the transaction price in Ind AS 115.
- Subsequent changes to the estimated amount of the consideration included in the gain or loss shall be accounted for in accordance with the requirements for changes in the transaction price in Ind AS 115.

2.8 DISCLOSURE

2.8.1 Disclosure- general

- The financial statements should disclose, for each class of property, plant and equipment:
  a) the measurement bases used for determining the gross carrying amount;
  b) the depreciation methods used;
  c) the useful lives or the depreciation rates used; and
  d) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period.
- Entity is also required to provide a reconciliation of the carrying amount at the beginning and end of the period showing:

a) additions;

b) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with Ind AS 105 and other disposals;

c) acquisitions through business combinations;

d) increases or decreases resulting from revaluations and from impairment losses recognised or reversed in other comprehensive income;

e) impairment losses recognised in profit or loss in accordance with Ind AS 36;

f) impairment losses reversed in profit or loss in accordance with Ind AS 36;

g) depreciation;

h) the net exchange differences arising on the translation of the financial statements from the functional currency into a different presentation currency, including the translation of a foreign operation into the presentation currency of the reporting entity; and

i) other changes.

- The financial statements are also disclose:

  a) the existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;

  b) the amount of expenditures recognised in the carrying amount of an item of property, plant and equipment in the course of its construction;

  c) the amount of contractual commitments for the acquisition of property, plant and equipment; and

  d) if it is not disclosed separately in the statement of profit and loss, the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in profit or loss.

2.8.2 Items stated at revalued amounts

- If items of property, plant and equipment are stated at revalued amounts, the following should be disclose:

  a) the effective date of the revaluation;

  b) whether an independent valuer was involved;

  c) for each revalued class of property, plant and equipment, the carrying amount that would have been recognised had the assets been carried under the cost model; and

  d) the revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.

2.8.3 Additional recommended disclosure

- Entities are encouraged but not required, to disclose the following amounts:

  a) the carrying amount of temporarily idle property, plant and equipment;

  b) the gross carrying amount of any fully depreciated property, plant and equipment that is still in use;

  c) the carrying amount of property, plant and equipment retired from active use and not classified as held for sale in accordance with Ind AS 105; and

  d) when the cost model is used, the fair value of property, plant and equipment when this is materially different from the carrying amount.

Illustration 8

MS Ltd. has acquired a heavy machinery at a cost of ₹ 1,00,00,000 (with no breakdown of the component parts). The estimated useful life is 10 years. At the end of the sixth year, one of the major components, the turbine requires replacement, as further maintenance is uneconomical. The remainder of the machine is perfect and is expected to last for the next four years. The cost of a new turbine is ₹ 45,00,000. The discount rate assumed is 5%.

Can the cost of the new turbine be recognised as an asset, and, if so, what treatment should be used?

Solution

The new turbine will produce economic benefits to MS Ltd., and the cost is measurable. Hence, the item should be recognised as an asset. The original invoice for the machine did not specify the cost of the turbine; however, the cost of the replacement ₹ 45,00,000 can be used as an indication (usually by discounting) of the likely cost, six years previously.

If an appropriate discount rate is 5% per annum, ₹ 45,00,000 discounted back six years amounts to ₹ 33,57,900 [₹ 45,00,000/$(1.05)^6$], i.e., the approximate cost of turbine before 6 years.

The current carrying amount of the turbine which is required to be replaced of ₹ 13,43,160 would be derecognised from the books of account, (i.e., Original Cost ₹ 33,57,900 as reduced by accumulated depreciation for past 6 years ₹ 20,14,740, assuming depreciation is charged on straight-line basis.)

The cost of the new turbine, ₹ 45,00,000 would be added to the cost of machine, resulting in a revision of carrying amount of machine to ₹ 71,56,840. (i.e., ₹ 40,00,000* – ₹ 13,43,160 + ₹ 45,00,000).

*Original cost of machine ₹ 1,00,00,000 reduced by accumulated depreciation (till the end of 6 years) ₹ 60,00,000.

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Illustration 9

On 1st April, 20X1, XYZ Ltd. acquired a machine under the following terms:

	₹
List price of machine	*80,00,000*
Import duty	*5,00,000*
Delivery fees	*1,00,000*
Electrical installation costs	*10,00,000*
Pre-production testing	*4,00,000*
Purchase of a five-year maintenance contract with vendor	*7,00,000*

In addition to the above information XYZ Ltd. was granted a trade discount of 10% on the initial list price of the asset and a settlement discount of 5%, if payment for the machine was received within one month of purchase. XYZ Ltd. paid for the plant on 20th April, 20X1. At what cost the asset will be recognised?

Solution

In accordance with Ind AS 16, all costs required to bring an asset to its present location and condition for its intended use should be capitalised. Therefore, the initial purchase price of the asset should be:

	₹
List price	80,00,000
Less: Trade discount (10%)	(8,00,000)
	72,00,000
Import duty	5,00,000
Delivery fees	1,00,000
Electrical installation costs	10,00,000
Pre-production testing	4,00,000
Total amount to be capitalised at 1st April, 20X1	**92,00,000**

Maintenance contract is a separate contract to get service, therefore, the maintenance contract cost of ₹ 7,00,000 should be taken as a prepaid expense and charged to the profit or loss over a period of 5 years.

In addition the settlement discount received of ₹ 3,60,000 (₹ 72,00,000 x 5%) is to be shown as other income in the profit or loss.

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Illustration 10

The term of an operating lease allows a tenant, XYZ Ltd. to tailor the property to meet its specific needs by building an additional internal wall, but on condition that the tenant returns the property at the end of the lease in its original state. This will entail dismantling the internal wall. XYZ Ltd. incurs a cost of ₹ 25,00,000 on building the wall and present value of estimated cost to dismantle the wall is ₹ 10,00,000. At what value should the leasehold improvements be capitalised in the books of XYZ Ltd.

Solution

The leasehold improvement is not only the cost of building the wall, but also the cost of restoring the property at the end of the lease. As such both costs i.e., ₹ 35,00,000 are capitalised when the internal wall is built and will be recognised in profit and loss over the useful life of the asset (generally the lease term) as a part of depreciation charge).

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Illustration 11

X Limited started construction on a building for its own use on 1st April, 20X0. The following costs are incurred:

	₹
Purchase price of land	*30,00,000*
Stamp duty & legal fee	*2,00,000*
Architect fee	*2,00,000*
Site preparation	*50,000*
Materials	*10,00,000*
Direct labour cost	*4,00,000*
General overheads	*1,00,000*

Other relevant information: Material costing ₹ 1,00,000 had been spoiled and therefore wasted and a further ₹ 1,50,000 was spent on account of faulty design work. As a result of these problems, work on the building was stopped for two weeks during November, 20X0 and it is estimated that ₹ 22,000 of the labour cost relate to that period. The building was completed on 1st January, 20X1 and brought in use 1st April, 20X1. X Limited had taken a loan of ₹ 40,00,000 on 1st April, 20X0 for construction of the building (which meets the definition of qualifying asset as per Ind AS 23). The loan carried an interest rate of 8% per annum and is repayable on 1st April, 20X2.
Calculate the cost of the building that will be included in tangible non-current asset as an addition?

Solution

Only those costs which are directly attributable to bringing the asset into working condition for its intended use should be included. Administration and general costs cannot be included. Cost of abnormal amount of wasted material/ labor or other resources is not included as per para 22 of Ind AS 16. Here, the cost of spoilt materials and faulty designs are assumed to be abnormal costs. Also it is assumed that the wastages and labor charges incurred are abnormal in nature. Hence, same are also not included in the cost of PPE.

Amount to be included in Property, Plant and Equipment (PPE):

	₹
Purchase price of land	30,00,000
Stamp duty & legal fee	2,00,000
Architect fee	2,00,000
Site preparation	50,000
Material (10,00,000 – 2,50,000)	7,50,000
Direct labour cost (4,00,000 – 22,000)	3,78,000
General overheads	Nil
Interest*	Nil
Total to be capitalized	**45,78,000**

*Period for Construction of building is not a substantial period (i.e. 9 months), borrowing cost are not eligible for capitalisation.

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Illustration 12

XYZ Ltd. purchased an asset on 1st January, 20X0, for ₹ 1,00,000 and the asset had an estimated useful life of ten years and a residual value of nil. The company has charged depreciation using the straight-line method at ₹ 10,000 per annum. On 1st January, 20X4, the management of XYZ Ltd. Reviews the estimated life and decides that the asset will probably be useful for a further four years and, therefore, the total life is revised to eight years. How should the asset be accounted for remaining years?

Solution

Change in useful economic life of an asset is change in accounting estimate, which is to be applied prospectively, i.e., the depreciation charge will need to be recalculated. On 1st January, 20X4, when the asset's net book value is ₹ 60,000. The company should amend the annual provision for depreciation to charge the unamortised cost (namely, ₹ 60,000) over the revised remaining life of four years. Consequently, it should charge depreciation for the next four years at ₹ 15,000 per annum.

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Illustration 13

On 1st April, 20X1, Sun ltd purchased some land for ₹ 10 million (including legal costs of ₹ 1 million) in order to construct a new factory. Construction work commenced on 1st May, 20X1. Sun ltd incurred the following costs in relation with its construction:

- *Preparation and levelling of the land – ₹ 3,00,000.*
- *Purchase of materials for the construction – ₹ 6·08 million in total.*
- *Employment costs of the construction workers – ₹ 2,00,000 per month.*
- *Overhead costs incurred directly on the construction of the factory – ₹ 1,00,000 per month.*
- *Ongoing overhead costs allocated to the construction project using the company's normal overhead allocation model – ₹ 50,000 per month.*
- *Income received during the temporary use of the factory premises as a car park during the construction period – ₹ 50,000.*
- *Costs of relocating employees to work at the new factory – ₹ 300,000.*
- *Costs of the opening ceremony on 31st January, 20X1 – ₹ 150,000.*

The factory was completed on 30th November, 20X1 and production began on 1st February, 20X2. The overall useful life of the factory building was estimated at 40 years from the date of completion. However, it is estimated that the roof will need to be replaced 20 years after the date of completion and that the cost of replacing the roof at current prices would be 30% of the total cost of the building.

At the end of the 40-year period, Sun Ltd has a legally enforceable obligation to demolish the factory and restore the site to its original condition. The directors estimate that the cost of demolition in 40 years' time (based on prices prevailing at that time) will be ₹ 20 million. An annual risk adjusted discount rate which is appropriate to this project is 8%. The present value of ₹ 1 payable in 40 years' time at an annual discount rate of 8% is ₹ 0.046.

The construction of the factory was partly financed by a loan of ₹ 17·5 million taken out on 1st April, 20X1. The loan was at an annual rate of interest of 6%. Sun Ltd received investment income of ₹ 100,000 on the temporary investment of the proceeds.

Required:

Compute the carrying amount of the factory in the Balance Sheet of Sun Ltd at 31st March, 20X2. You should explain your treatment of all the amounts referred to in this part in your answer.

Solution

Computation of the cost of the factory

Description	Included in P.P.E. ₹ '000	Explanation
Purchase of land	10,000	Both the purchase of the land and the associated legal costs are direct costs of constructing the factory.
Preparation and levelling	300	A direct cost of constructing the factory
Materials	6,080	A direct cost of constructing the factory
Employment costs of construction workers	1,400	A direct cost of constructing the factory for a seven-month period
Direct overhead costs	700	A direct cost of constructing the factory for a seven-month period
Allocated overhead costs	Nil	Not a direct cost of construction
Income from use as a car park	Nil	Not essential to the construction so recognised directly in profit or loss
Relocation costs	Nil	Not a direct cost of construction
Opening ceremony	Nil	Not a direct cost of construction
Finance costs	612.50	Capitalise the interest cost incurred in a seven-month period (purchase of land would not trigger off capitalisation since land is not a qualifying asset. Infact, the construction started from 1st May, 20X1)
Investment income on temporary investment of the loan proceeds	(100)	offset against the amount capitalised
Demolition cost recognised as a provision	920	Where an obligation must recognise as part of the initial cost
Total	19,912.50	
Computation of accumulated depreciation		
Total depreciable amount	9,912.50	All of the net finance cost of 512.50 (612.50 – 100) has been allocated to the depreciable amount. Also acceptable to reduce by allocating a portion to the non-depreciable land element principle
Depreciation must be in two parts:		
Depreciation of roof component	49.56	9,912.50 x 30% x 1/20 x 4/12
Depreciation of remainder	57.82	9,912.50 x 70% x 1/40 x 4/12

Total depreciation	107.38	
Computation of carrying amount	19,805.12	19,912.50 – 107.38

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2.9 SIGNIFICANT DIFFERENCES IN IND AS 16 *VIS-À-VIS* AS 10

S. No.	Particular	Ind AS 16	AS 10
1.	*Fixed Assets retired from Active Use and Held for Sale*	Ind AS 16 does not deal with the assets 'held for sale' because the treatment of such assets is covered in Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations.	AS 10 deals with accounting for items of fixed assets retired from active use and held for sale.
2.	*Stripping Costs in the Production Phase of a Surface Mine*	Ind AS 16 provides guidance on measuring 'Stripping Costs in the Production Phase of a Surface Mine'.	AS 10 does not contain this guidance.

TEST YOUR KNOWLEDGE

Questions

1. ABC Ltd. is installing a new plant at its production facility. It has incurred these costs:

1.	Cost of the plant (cost per supplier's invoice plus taxes)	₹ 25,00,000
2.	Initial delivery and handling costs	₹ 2,00,000
3.	Cost of site preparation	₹ 6,00,000
4.	Consultants used for advice on the acquisition of the plant	₹ 7,00,000
5.	Interest charges paid to supplier of plant for deferred credit	₹ 2,00,000
6.	Net present value of estimated dismantling costs to be incurred after 7 years	₹ 3,00,000
7.	Operating losses before commercial production	₹ 4,00,000

Please advise ABC Ltd. on the costs that can be capitalized in accordance with Ind AS 16.

2. A Ltd. has an item of property, plant and equipment with an initial cost of ₹ 1,00,000. At the date of revaluation, accumulated depreciation amounted to ₹ 55,000. The fair value of the asset, by reference to transactions in similar assets, is assessed to be ₹ 65,000.

Pass Journal Entries with regard to Revaluation?

3. B Ltd. owns an asset with an original cost of ₹ 2,00,000. On acquisition, management determined that the useful life was 10 years and the residual value would be ₹ 20,000. The asset is now 8 years old, and during this time there have been no revisions to the assessed residual value.

At the end of year 8, management has reviewed the useful life and residual value and has determined that the useful life can be extended to 12 years in view of the maintenance program adopted by the company. As a result, the residual value will reduce to ₹ 10,000.

How would the above changes in estimates be accounted by B Ltd.?

4. X Ltd. has a machine which got damaged due to fire as on 31st January, 20X1. The carrying amount of machine was ₹ 1,00,000 on that date. X Ltd. sold the damaged asset as scrap for ₹ 10,000. X Ltd. has insured the same asset against damage. As on 31st March, 20X1, the compensation proceeds was still in process but the insurance company has confirmed the claim. Compensation of ₹ 50,000 is receivable from the insurance company. How X Ltd. will account for the above transaction?

5. An entity has a nuclear power plant and a related decommissioning liability. The nuclear power plant started operating on 1st April, 2XX1. The plant has a useful life of 40 years. Its initial cost was ₹ 1,20,000 which included an amount for decommissioning costs of ₹ 10,000, which represented ₹ 70,400 in estimated cash flows payable in 40 years discounted at a risk-adjusted rate of 5 per cent. The entity's financial year ends on 31st March. On March, 2X11, the net present value of the decommissioning liability has decreased by ₹ 8,000. The discount rate has not yet changed.

How the entity will account for the above changes in decommissioning liability in the year 2X11, if it adopts cost model?

6. An entity has a nuclear power plant and a related decommissioning liability. The nuclear power plant started operating on 1st April, 20X1. The plant has a useful life of 40 years. Its initial cost was ₹ 1,20,000. This included an amount for decommissioning costs of ₹ 10,000, which represented ₹ 70,400 in estimated cash flows payable in 40 years discounted at a risk-adjusted rate of 5 per cent. The entity's financial year ends on 31st March. Assume that a market-based discounted cash flow valuation of ₹ 1,15,000 is obtained at 31st March, 20X4. This valuation is after deduction of an allowance of ₹ 11,600 for decommissioning costs, which represents no change to the original estimate, after the unwinding of three years' discount. On 31st March, 20X5, the entity estimates that, as a result of technological advances, the present value of the decommissioning liability has decreased by ₹ 5,000. The entity decides that a full valuation of the asset is needed at 31st March, 20X5, in order to ensure that the carrying amount does not differ materially from fair value. The asset is now valued at ₹ 1,07,000, which is net of an allowance for the reduced decommissioning obligation.

How the entity will account for the above changes in decommissioning liability if it adopts revaluation model?

Answers

1. According to Ind AS 16, these costs can be capitalized:

1.	Cost of the plant	₹ 25,00,000
2.	Initial delivery and handling costs	₹ 2,00,000
3.	Cost of site preparation	₹ 6,00,000
4.	Consultants' fees	₹ 7,00,000
5.	Net present value of estimated dismantling costs to be incurred after 7 years	₹ 3,00,000
		₹ 43,00,000

Note: Interest charges paid on "Deferred credit terms" to the supplier of the plant (not a qualifying asset) of ₹ 2,00,000 and operating losses before commercial production amounting to ₹ 4,00,000 are not regarded as directly attributable costs and thus cannot be capitalized. They should be written off to the Statement of Profit and Loss in the period they are incurred.

2. The entries to be passed would be:

		₹	₹
Accumulated depreciation	Dr.	55,000	
To Asset A/c			55,000
(Being elimination of accumulated depreciation against the cost of the asset)			
Asset A/c	Dr	20,000	
To Revaluation Surplus			20,000
(Being increase of net asset value to Fair value)			

Note: The net result is that the asset has a carrying amount of ₹ 65,000 [1,00,000 – 55,000 + 20,000.]

3. **Calculation of accumulated depreciation till 8th year**

Depreciable amount {Cost less residual value} = ₹ 2,00,000 – ₹ 20,000 = ₹ 1,80,000.

Annual depreciation = Depreciable amount / Useful life = 1,80,000 / 10 = ₹ 18,000.

Accumulated depreciation = 18,000 x No. of years (8) = ₹ 1,44,000.

Calculation of carrying amount at the end of the 8th year

The asset has a carrying amount of ₹ 56,000 at the end of year 8 [ie. ₹ 2,00,000 – ₹ 1,44,000]

Accounting of the changes in estimates

Revision of the useful life to 12 years results in a remaining useful life of 4 years (ie 12 years – 8 years).

The revised depreciable amount is ₹ 46,000 (₹ 56,000 – ₹ 10,000)

Thus, depreciation should be charged in future ie from 9th year onwards at ₹ 11,500 per annum (₹ 46,000 / 4 years).

4. As per para 66 of Ind AS 16, impairment or losses of items of property, plant and equipment and related claims for or payments of compensation from third parties are separate economic events and should be accounted for separately.

X Ltd. should account for the above transaction as given below:

At the time of sale of scrap machine, X Ltd. should write off the carrying amount of asset from books of account and provide a loss of ₹ 90,000. (i.e., carrying amount of ₹ 1,00,000 – realised amount of ₹ 10,000)

As on 31st March, 20X1, X Ltd. should recognise income of ₹ 50,000 against the compensation receivable in its profit or loss.

5. On 31st March, 2X11, the plant is 10 years old. Accumulated depreciation is ₹ 30,000 (₹ 120,000 x 10 / 40 years). Due to unwinding of discount @ 5% over the 10 years, the amount of decommissioning liability has increased from ₹ 10,000 to ₹ 16,300 (approx.).

On 31st March, 2X11, the discount rate has not changed. However, the entity estimates that, as a result of technological advances, the net present value of the decommissioning liability has decreased by ₹ 8,000. Accordingly, the entity adjusts the decommissioning liability from ₹ 16,300 to ₹ 8,300. On this date, the entity passes the following journal entry to reflect the change:

		₹	₹
Provision for decommissioning liability	Dr.	8,000	
To Asset			8,000

Following this adjustment, the carrying amount of the asset is ₹ 82,000 (₹ 1,20,000 – ₹ 8,000 – ₹ 30,000), which will be depreciated over the remaining 30 years of the asset's life giving a depreciation expense for the next year of ₹ 2,733 (₹ 82,000 / 30). The next year's finance cost for unwinding of discount will be ₹ 415 (₹ 8,300 × 5 per cent).

6.

At 31st March, 20X4:	**₹**
Asset at valuation (1)	1,26,600
Accumulated depreciation	Nil
Decommissioning liability	(11,600)
Net assets	1,15,000
Retained earnings (2)	(10,600)
Revaluation surplus (3)	5,600

Notes:

(1) When accounting for revalued assets to which decommissioning liabilities attach, it is important to understand the basis of the valuation obtained. For example:

(a) if an asset is valued on a discounted cash flow basis, some valuers may value the asset without deducting any allowance for decommissioning costs (a 'gross' valuation), whereas others may value the asset after deducting an allowance for decommissioning costs (a 'net' valuation), because an entity acquiring the asset will generally also assume the decommissioning obligation. For financial reporting purposes, the decommissioning obligation is recognised as a separate liability, and is not deducted from the asset. Accordingly, if the asset is valued on a net basis, it is necessary to adjust the valuation obtained by adding back the allowance for the liability, so that the liability is not counted twice.

(b) if an asset is valued on a depreciated replacement cost basis, the valuation obtained may not include an amount for the decommissioning component of the asset. If it does not, an appropriate amount will need to be added to the valuation to reflect the depreciated replacement cost of that component.

Since, the asset is valued on a net basis, it is necessary to adjust the valuation obtained by adding back the allowance for the liability. Valuation obtained of ₹ 1,15,000 plus decommissioning costs of ₹ 11,600, allowed for in the valuation but recognised as a separate liability = ₹ 1,26,600.

(2) Three years' depreciation on original cost ₹ 1,20,000 × 3/40 = ₹ 9,000 plus cumulative discount on ₹ 10,000 at 5 per cent compound = ₹ 1,600; total ₹ 10,600.

(3) Revalued amount ₹ 1,26,600 less previous net book value of ₹ 1,11,000 (cost ₹ 120,000 less accumulated depreciation ₹ 9,000).

The depreciation expense for 20X4-20X5 is therefore ₹ 3,420 (₹ 1,26,600 x 1 / 37) and the discount expense for 20X5 is ₹ 600. On 31st March, 20X5, the decommissioning liability (before any adjustment) is ₹ 12,200. However, as per estimate of the entity, the present value of the decommissioning liability has decreased by ₹ 5,000. Accordingly, the entity adjusts the decommissioning liability from ₹ 12,200 to ₹ 7,200.

The whole of this adjustment is taken to revaluation surplus, because it does not exceed the carrying amount that would have been recognised had the asset been carried under the cost model. If it had done, the excess would have been taken to profit or loss. The entity makes the following journal entry to reflect the change:

		₹	₹
Provision for decommissioning liability	Dr.	5,000	
To Revaluation surplus			5,000

As at 31st March, 20X5, the entity revalued its asset at ₹ 1,07,000, which is net of an allowance of ₹ 7,200 for the reduced decommissioning obligation that should be recognised as a separate liability. The valuation of the asset for financial reporting purposes, before deducting this allowance, is therefore ₹ 1,14,200. The following additional journal entry is needed:

Notes:

		₹	₹
Accumulated depreciation (1)	Dr.	3,420	
To Asset at valuation			3,420

Revaluation surplus (2)	Dr.	8,980	
To Asset at valuation (3)			8,980

(1) Eliminating accumulated depreciation of ₹ 3,420 in accordance with the entity's accounting policy.

(2) The debit is to revaluation surplus because the deficit arising on the revaluation does not exceed the credit balance existing in the revaluation surplus in respect of the asset.

(3) Previous valuation (before allowance for decommissioning costs) ₹ 1,26,600, less cumulative depreciation ₹ 3,420, less new valuation (before allowance for decommissioning costs) ₹ 1,14,200.

Following this valuation, the amounts included in the balance sheet are:

Asset at valuation	1,14,200
Accumulated depreciation	Nil
Decommissioning liability	(7,200)
Net assets	1,07,000
Retained earnings (1)	(14,620)
Revaluation surplus (2)	11,620

Notes:

(1) ₹ 10,600 at 31st March, 20X4, plus depreciation expense of ₹ 3,420 and discount expense of ₹ 600 = ₹ 14,620.

(2) ₹ 15,600 at 31st March, 20X4, plus ₹ 5,000 arising on the decrease in the liability, less ₹ 8,980 deficit on revaluation = ₹ 11,620.

Following this valuation, the amounts included in the balance sheet are:

Asset at valuation	1,14,200
Accumulated depreciation	Nil
Decommissioning liability	(7,200)
Net assets	1,07,000
Retained earnings (1)	(14,620)
Revaluation surplus (2)	11,620

Notes:

(1) ₹ 10,600 at 31st March, 20X4, plus depreciation expense of ₹ 3,420 and discount expense of ₹ 600 = ₹ 14,620.

(2) ₹ 15,600 at 31st March, 20X4, plus ₹ 5,000 arising on the decrease in the liability, less ₹ 8,980 deficit on revaluation = ₹ 11,620.

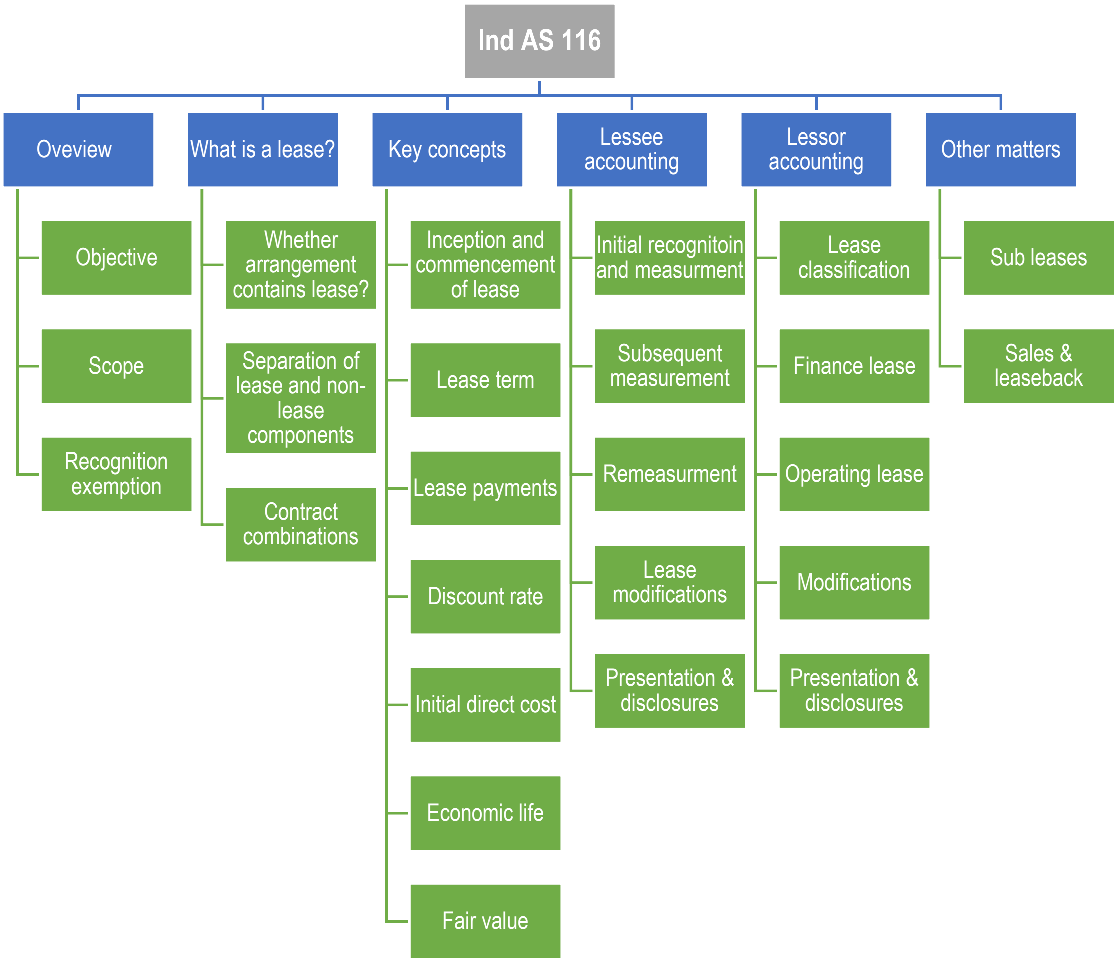
UNIT 3: INDIAN ACCOUNTING STANDARD 116 : LEASES

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Appreciate the scope and definition of the standard
- Comprehend the criteria for recognition of lease
- Analyse whether an arrangement contains a lease
- Identify and separate the lease and non-lease components of a contract
- Understand the concept of inception and commencement of lease
- Determine Lease Term
- Identify other key concepts like lease payments, discount rate and economic life
- Matriculate the accounting in the books of Lessee with respect to recognition, measurement, presentation and disclosure aspects
- Learn the accounting in the books of Lessor Accounting with respect to recognition, measurement, presentation and disclosure aspects
- Gain knowledge of accounting for subleases and sale and lease back transactions
- Understand the transitional provisions

UNIT OVERVIEW



3.1 OVERVIEW

Ministry of Corporate Affairs (MCA) has notified new standard on leases i.e Ind AS 116 vide its notification dated 30th March, 2019. Lease accounting has undergone significant changes on introduction of Ind AS 116 which is fully converged with IFRS 16. This new standard replaced the erstwhile Ind AS 17 and is effective from financial periods beginning on or after 1st April, 2019.

Ind AS 17 was based on dual classification model of operating and finance leases with different classification and measurement guidance for each of them. The dual classification model did not account for the assets and liabilities associated with the rights and obligations that arise out of the most "operating" leases.

Ind AS 116, Leases, requires most leases to be recognized on the balance sheet and requires enhanced disclosures. It is believed that this will result in a more faithful representation of lessees' assets and liabilities and greater transparency about the lessee's obligations and leasing activities. However, Ind AS 116 does not make fundamental changes to existing lessor accounting model.

3.1.1 Objective

The objective of this standard is to ensure that lessees and lessors provide relevant information in a manner that faithfully represents those transactions. This information gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of an entity. This standard requires an entity to consider the terms and conditions of contracts and all relevant facts and circumstances, and to apply the standard consistently to contracts with similar characteristics and in similar circumstances.

For many reporting entities, leasing is an important way to obtain access to property. A leasing arrangement conveys the use of an asset from one party to another without transferring ownership. The leasing arrangement may take various forms. Some arrangements are clearly within the scope of lease accounting, for example, property lease that provides an explicit contractual right to use a building for a specified period of time in exchange for consideration. However, the right to use an asset can also be conveyed through arrangements that are not leases in form. Therefore, it is very critical to assess as to which arrangement contains a lease for assessing correct impact on financial position.

Ind AS 116, Leases, identifies arrangements that are to be accounted for as leases. This unit discusses how to identify which arrangements, or components within an arrangement, should be accounted for under Ind AS 116 and sets out the principles for the recognition, measurement, presentation and disclosure of leases.

3.1.2 Scope

Ind AS 116 shall be applied to ALL LEASES, including leases of Right-of-Use (ROU) assets in a sub-lease, **EXCEPT** for:

Sr. No.	Particulars	Reason
1	Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources	Within the scope of Ind AS 106 *'Exploration for and Evaluation of Mineral Resources'*
2	Leases of biological assets held by a lessee	Within the scope of Ind AS 41 *'Agriculture'*
3	Service concession arrangements	Within the scope of Appendix D of Ind AS 115 *'Revenue from Contracts with Customers'*
4	Licences of intellectual property granted by a lessor	Within the scope of Ind AS 115 *'Revenue from Contracts with Customers'*
5#	Rights held by a lessee under licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights	Within the scope of Ind AS 38 *'Intangible Assets'*

#A lessee may, but is not required to, apply Ind AS 116 to leases of intangible assets other than those described herein.

3.1.3 Recognition Exemptions

In addition to above scope exclusions, a lessee can elect not to apply Ind AS 116's recognition requirements to:

1. Short-term leases; and
2. Leases for which the underlying asset is of low-value

If a lessee **elects to apply** the above recognition exemption, the lessee shall recognise **the lease payments** associated with those leases as an expense on **either a straight-line basis over the lease term or another systematic basis**, if that basis is more representative of the pattern of the lessee's benefit.

Short term leases:

A short-term lease is a lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset. As the determination is made at the commencement date, a lease cannot be classified as short-term if the lease term is subsequently reduced to less than 12 months.

The short-term lease exemption can be made by **class of underlying asset** to which the right of use relates. A class of underlying asset is a grouping of underlying assets of a similar nature and use in an entity's operations. For example, consider an entity which has leased several items of office equipment - some of them for less than 12 months and some for more than 12 months, with none containing purchase options. Assuming that the items of office equipment are all considered to be of the same class, if the entity wishes to use the short term lease exemption it must apply that exemption for all of the leases with terms of 12 months or less. The leases with terms longer than 12 months will be accounted for in accordance with the general recognition and measurement requirements for lessees.

A lessee that makes this election must make certain quantitative and qualitative disclosures about short-term leases. Once a lessee establishes a policy for a class of underlying assets, all future short-term leases for that class are required to be accounted for in accordance with the lessee's policy.

Illustration 1 - Short-term lease

Scenario A:

A lessee enters into a lease with a nine-month non-cancellable term with an option to extend the lease for four months. The lease does not have a purchase option. At the lease commencement date, the lessee is reasonably certain to exercise the extension option because the monthly lease payments during the extension period are significantly below market rates. Whether the lessee can take a short-term exemption in accordance with Ind AS 116?

Scenario B:

Assume the same facts as Scenario A except, at the lease commencement date, the lessee is not reasonably certain to exercise the extension option because the monthly lease payments during the optional extension period are at what the lessee expects to be market rates and there are no other factors that would make exercise of the renewal option reasonably certain. Will your answer be different in this case?

Solution:

Scenario A:

As the lessee is reasonably certain to exercise the extension option (Refer section 3.2 lease term), the lease term is greater than 12 months (i.e., 13 months). Therefore, the lessee will not account for the lease as a short-term lease.

Scenario B:

In this case, the lease term is less than 12 months, i.e., nine months. Thus, the lessee may account for the said lease under the short-term lease exemption, i.e., it recognises lease payments as an expense on either a straight-line basis over the lease term or another systematic basis.

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Leases of low-value assets:

Lessees can also make an election for leases for which the underlying asset is of low value (i.e., low-value assets).

Though Ind AS 116 does not explicitly define the leases of low-value assets, it provides the conditions based on which an asset can be treated as of low-value and the said exemption can be availed accordingly for such low-value asset(s). Following are the conditions:

An underlying asset can be of low value **ONLY IF BOTH** the following conditions are satisfied:

- The lessee can benefit from use of the underlying asset on its own or together with other resources that are readily available to the lessee
- The underlying asset is not highly dependent on, or highly interrelated with, other assets

This can be understood with the help of the following example:

An entity may lease a car for use in its business and the lease includes the use of the tyres attached to the car. To use the tyres for their intended purpose, they can only be used with the car and as such, they are dependent on, or highly interrelated with the car. Therefore, the tyres would not qualify for the low-value asset exemption.

The election for leases for which the underlying asset is of low value can be made on a **lease-by-lease basis**. For example, an entity enters into a rental contract for a large number of laptops. Each laptop within the contract constitutes an identified asset. Entity has considered that the value of individual laptop would be low, even though the contract for all the laptops is not. The conditions of Para B5 of Ind AS 116 are satisfied i.e., the entity can benefit from use of an individual laptop together with other resources that are already available and each laptop does not need other assets to make it functional. Consequently, each laptop qualifies as a low value asset and the entity can elect to apply the low-value exemption to all the laptops under the contract.

The exemption for leases of low—value items intends to capture leases that are high in volume but low in value — e.g. leases of small IT equipment (laptops, mobile phones, simple printers), leases of office furniture etc. Ind AS 116 is silent on any threshold to determine the value for classifying any asset as low value assets.

The following boxes depicts the important points regarding the leases of low-value assets:

Value of an underlying asset to be assessed based on the value of the asset when it is new, regardless of the age of the asset being leased *

Leases of low-value assets are exempted regardless of whether those leases are material to the lessee

Examples of low-value underlying assets can include:

- tablet
-personal computers,
- small items of office furniture
- telephones

The assessment performed on an absolute basis. It is not affected by the size, nature or circumstances of the lessee.

*A lease of an underlying asset does not qualify as a lease of low value asset if the nature of the asset is such that, when new, the asset is typically not of low value. ***For e.g.***, leases of cars would not qualify as leases of low-value assets because a new car would typically not be of low value.

Head leases do not qualify as low value assets:

It is very important to note that if a lessee subleases an asset, or expects to sublease an asset, the head lease does not qualify as a lease of a low-value asset, i.e., an intermediate lessor who subleases, or expects to sublease an asset, cannot account for the head lease as a lease of a low-value asset. (Refer section 6.1 sublease)

Then, what should be the approach for such leases when the said exemptions are taken?

The lease payments shall be recognised as an expense on either a Straight-line basis over the lease term or another systematic basis, if that basis is more representative of the pattern of the lessee's benefit.

If a lessee accounts for "short-term leases" as per the approach mentioned above, it shall consider the lease to be a "new lease" for the purposes of Ind AS 116 if:

(a) there is a lease modification; ***OR***

(b) there is any change in the lease term

3.2 WHAT IS A LEASE?

At the inception of a contract, an entity shall assess whether the contract is or contains a lease. For the purpose, a lease is defined as a contract, or part of a contract that conveys the **right to control** the use of an **identified asset** for a **period of time** in **exchange for consideration**.

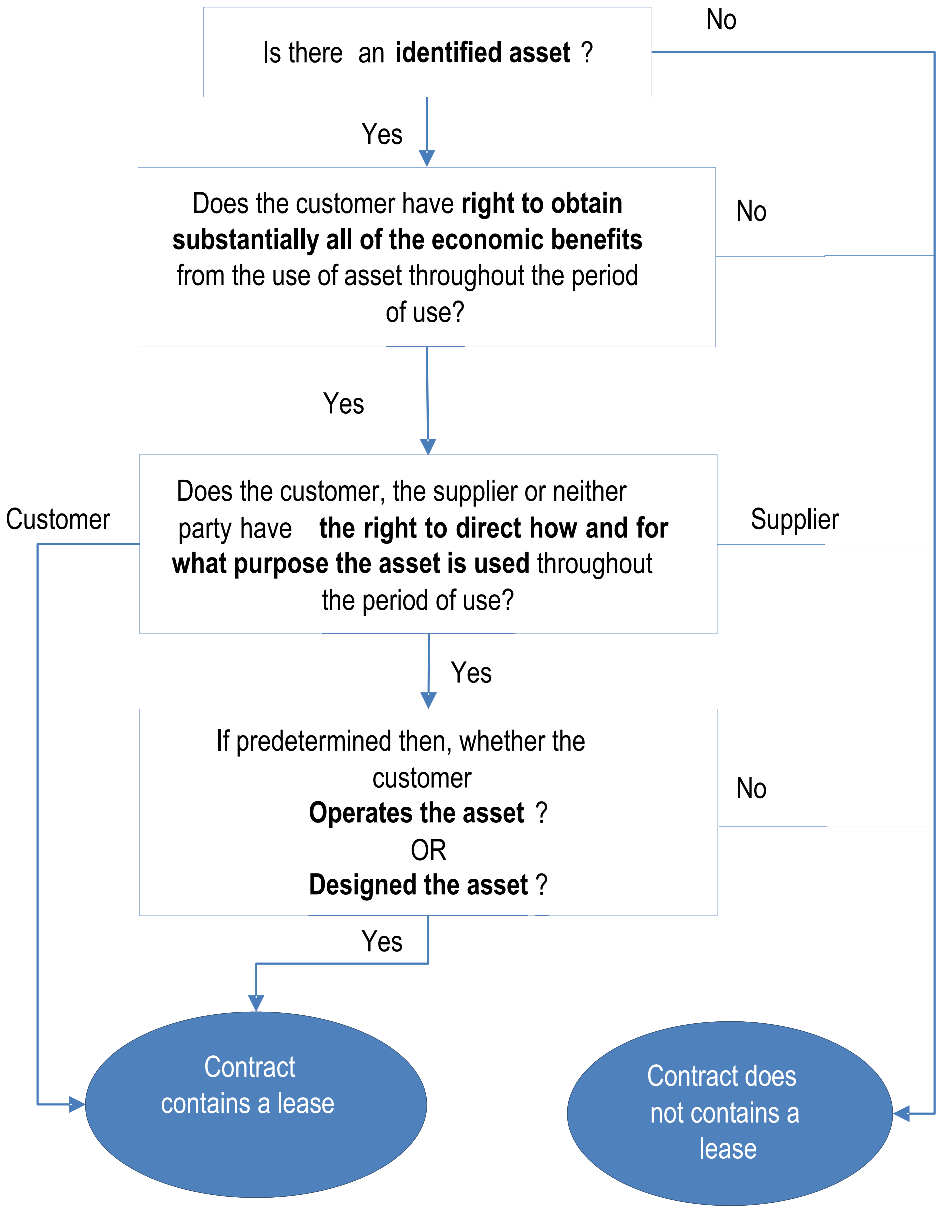
Ind AS 116 requires customers and suppliers to determine whether a contract is or contains a lease at the inception of the contract.

The inception date is defined as the ***earlier*** of the following dates:

- date of a lease agreement
- date of commitment by the parties to the principal terms and conditions of the lease

'A period of time' may be described in terms of the amount of use of an identified asset (***for e.g.***, the number of production units that an item of equipment will be used to produce). It includes any non-consecutive periods of time.

3.2.1 Whether an Arrangement Contains Lease?



3.2.1.1 Identified Asset

An arrangement only contains a lease if there is an **identified asset**. Under Ind AS 116, an identified asset can be explicitly specified in a contract or implicitly specified at the time that the asset is made available for use by the customer.

Illustration 2 - Asset implicitly specified in a contract

Customer XYZ enters into a ten-year contract with Supplier ABC for the use of rolling stock specifically designed for Customer XYZ.

The rolling stock is designed to transport materials used in Customer XYZ's production process and is not suitable for use by other customers. The rolling stock is not explicitly specified in the contract but, Supplier ABC owns only one rolling stock that is suitable for Customer XYZ's use. If the rolling stock does not operate properly, the contract requires Supplier ABC to repair or replace the rolling stock.

Whether there is an identified asset?

Solution:

Yes, the said rolling stock is an identified asset.

Though the rolling stock is not explicitly specified in the contract (e.g., by serial number), it is implicitly specified because Supplier ABC must use it to fulfil the contract.

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Illustration 3 (Asset implicitly specified in a contract):

Customer XYZ enters into a ten-year contract with Supplier ABC for the use of a car. The specification of the car is specified in the contract (i.e., brand, type, colour, options, etc.). At inception of the contract, the car is not yet built.

Whether there is an identified asset?

Solution:

Yes, the said car is an identified asset.

Though the car cannot be identified at inception of the contract, it is **implicitly specified** at the time the same will be made available to Customer XYZ.

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Substantive Substitution Rights:

This is a very important concept since without evaluating this condition, the conclusion as to whether there is an identified asset cannot be attained. So, even if an asset is specified, a customer does not have the right to use an identified asset if, at inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use.

A supplier's right to substitute an asset is **SUBSTANTIVE** when **BOTH** of the following conditions are met:

The supplier has the **PRACTICAL ABILITY** to substitute alternative assets throughout the period of use (***for e.g.***, the customer cannot prevent the supplier from substituting an asset and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time).

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The supplier would **BENEFIT ECONOMICALLY** from the exercise of its right to substitute the asset (i.e., the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

→ Substantive Substitution Rights

The conditions above are intended to differentiate between substitution rights that result in a supplier controlling the use of an asset, rather than the customer, and rights that do not change the substance or character of the contract.

In the case of substitution rights, the analysis primarily considers factors from the supplier's perspective. Examples of factors to consider include (1) transportation costs of relocating one asset to a location where it can be used to satisfy the arrangement or to move the output from the production location to the customer, (2) foregone production resulting from down time necessary to switch assets and other disruptions to the suppliers' business, (3) excess operational costs to convert an asset that may not have produced identical output, etc.

Further, if the supplier has a right or an obligation to substitute the asset only on or after either a **particular date**, or the occurrence of a specified event, the supplier's substitution right is **not substantive** because the supplier does **not have the practical ability** to substitute alternative assets **throughout the period of use**.

An entity's evaluation of whether a supplier's substitution right is substantive is based on **facts and circumstances at inception** of the contract. At inception of the contract, an entity should not consider future events that are not likely to occur. Ind AS 116 provides the following examples of circumstances that, at inception of the contract, are not likely to occur and, thus, are **excluded** from the evaluation of whether a supplier's substitution right is substantive throughout the period of use:

(1) An agreement by a future customer to pay an above market rate for use of the asset	(2) The introduction of new technology that is not substantially developed at inception of the contract
(3) A substantial difference between the customer's use of the asset, or the performance of the asset, and the use or performance considered likely at inception of the contract	(4) A substantial difference between the market price of the asset during the period of use, and the market price considered likely at inception of the contract

The requirement that a substitution right must **benefit the supplier economically** in order to be substantive is a new concept. In many cases, it will be clear that the supplier will not benefit from the exercise of a substitution right because of the costs associated with substituting an asset. The physical location of the asset may affect the costs associated with substituting the asset. ***For e.g.***, if an asset is located at the customer's premises, the cost associated with substituting it is generally higher than the cost of substituting a similar asset located at the supplier's premises. However, simply because a supplier concludes that the cost of substitution is not significant does not automatically mean that it would economically benefit from the right of substitution.

Ind AS 116 further clarifies that a customer should **presume** that a supplier's substitution right is **not substantive** when the customer **cannot readily determine** whether the supplier has a substantive substitution right. This requirement is intended to clarify that a **customer is not expected to exert undue effort to provide evidence that a substitution right is not substantive**. However, suppliers should have sufficient information to make a determination of whether a substitution right is substantive.

Contract terms that allow or require a supplier to substitute alternative assets only when the underlying asset is not operating properly (***for e.g.***, a normal warranty provision) or when a technical upgrade becomes available do not create a substantive substitution right.

Illustration 4 - Substantive Substitution Rights

Scenario A:

An electronic data storage provider (supplier) provides services through a centralised data centre that involve the use of a specified server (Server No. 10). The supplier maintains many identical servers in a single accessible location and determines, at inception of the contract, that it is permitted to and can easily substitute another server without the customer's consent throughout the period of use.

Further, the supplier would benefit economically from substituting an alternative asset, because doing this would allow the supplier to optimise the performance of its network at only a nominal cost. In addition, the supplier has made clear that it has negotiated this right of substitution as an important right in the arrangement, and the substitution right affected the pricing of the arrangement.

Whether the substitution rights are substantive and whether there is an identified asset?

Scenario B:

Assume the same facts as in Scenario A except that Server No. 10 is customised, and the supplier does not have the practical ability to substitute the customised asset throughout the period of use. Additionally, it is unclear whether the supplier would benefit economically from sourcing a similar alternative asset.

Whether the substitution rights are substantive and whether there is an identified asset?

Solution

Scenario A:

The customer does not have the right to use an identified asset because, at the inception of the contract, the supplier has the practical ability to substitute the server and would benefit economically from such a substitution. Thus, there is no identified asset.

However, if the customer could not readily determine whether the supplier had a substantive substitution right (***for e.g.***, there is insufficient transparency into the supplier's operations), the customer would **presume** the substitution right is not substantive and conclude that there is an identified asset.

Scenario B:

The substitution right is not substantive, and Server No. 10 would be an identified asset because the supplier does not have the practical ability to substitute the asset and there is no evidence of economic benefit to the supplier for substituting the asset. In this case, neither of the conditions of a substitution right is met (whereas both the conditions must be met for the supplier to have a substantive substitution right). Therefore, Server No 10 will be considered as an identified asset.

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Identified Asset – Physically Distinct:

An identified asset must be physically distinct. A physically distinct asset may be an entire asset or a portion of an asset. For example, a building is generally considered physically distinct, but one floor within the building may also be considered physically distinct if it can be used independent of the other floors. Similarly, a capacity or other portion of an asset that is not physically distinct (***for e.g.***, a capacity portion of a fibre optic cable) is not an identified asset unless it represents **substantially all** of the capacity of the asset and thereby provides the customer with the **right to obtain substantially all of the economic benefits** from use of the asset.

The term "substantially all" is not defined in Ind AS 116.

This can be better understood with the help of the following illustrations:

Illustration 5 (Identified Asset – Physically Distinct):

Customer XYZ enters into a 15-year contract with Supplier ABC for the right to use five fibres within a fibre optic cable between Mumbai and Pune. The contract identifies five of the cable's 25 fibres for use by Customer XYZ. The five fibres are dedicated solely to Customer XYZ's data for the duration of the contract term. Assume that Supplier ABC does not have a substantive substitution right.

Whether there is an identified asset?

Solution:

Yes, the said five fibres are identified assets because they are physically distinct and explicitly specified in the contract.

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Illustration 6 (Identified Asset – Not Physically Distinct):

Scenario A:

Customer XYZ enters into a ten-year contract with Supplier ABC for the right to transport oil from India to Bangladesh through Supplier ABC's pipeline. The contract provides that Customer XYZ will have the right to use of 95% of the pipeline's capacity throughout the term of the arrangement.

Whether there is an identified asset?

Scenario B:

Assume the same facts as in Scenario A, except that Customer XYZ has the right to use 65% of the pipeline's capacity throughout the term of the arrangement.

Whether there is an identified asset?

Solution:

Scenario A:

Yes, the capacity portion of the pipeline is an identified asset.

While 95% of the pipeline's capacity is not physically distinct from the remaining capacity of the pipeline, it represents **substantially all of the capacity** of the entire pipeline and thereby provides Customer XYZ with the **right to obtain substantially all of the economic benefits** from use of the pipeline.

Scenario B:

No, the capacity portion of the pipeline is **NOT** an identified asset.

Since 65% of the pipeline's capacity is **less than substantially all** of the capacity of the pipeline, Customer XYZ does **not have the right to obtain substantially all of the economic benefits** from use of the pipeline.

*****

3.2.1.2 Right to Control

To assess whether a contract conveys the right to control the use of an identified asset for a period of time, an entity shall assess whether, throughout the period of use, the customer has both of the following:

(a) The right to obtain **substantially all of the economic benefits** from use of the identified asset; **and**

(b) The **right to direct the use** of the identified asset

The right to control the use of an asset may not necessarily be documented, in form, as a lease agreement. Often, the right to use an identified asset is embedded in an arrangement that may appear to be a supply arrangement or service contract. Therefore, a reporting entity should consider all of the terms of an arrangement to determine whether it contains a lease.

Further, if the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

Illustration 7 (Right to use for a portion of the term of contract):

ABC Ltd enters into a contract with XYZ Ltd, which grants ABC Ltd exclusive rights to use a specific grain storage facility over a five-year period in the months of May and June. During these months, ABC Ltd has the right to decide which crops are placed in storage and when to remove them. XYZ Ltd provides the loading and unloading services for the warehouse activities. During the other ten months each year, XYZ Ltd has the right to determine how the warehouse will be used.

Which party has the right to control the use of the identified asset during the period of use?

Solution:

In the above case, ABC Ltd has the right to control the use of the identified asset during the period of use because they have the power to determine how the warehouse will be used during the contractually defined usage periods. The analysis should focus on the rights and economics of the use of the warehouse for the specified usage periods (May and June). During the period of use, ABC Ltd has the rights to determine how much of a crop to place in storage, and the timing of placing and removing it from storage. These rights are more significant to the economics of the use of the asset than the loading and unloading services performed by XYZ Ltd during the same period. ABC Ltd receives all of the economic benefit from use of the asset during those specified time periods. Therefore, contract contains a lease for the specified period of term.

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Right to Obtain Substantially All of the Economic Benefits:

The first criterion in the control assessment is to determine whether the customer has the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use, i.e., to control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use (***for e.g.***, by having exclusive use of the asset throughout that period).

A customer can obtain economic benefits either **directly** or **indirectly** (***for e.g.***, by using, holding or subleasing the asset). Economic benefits from use of an asset include:

- the asset's primary outputs (i.e., goods or services)
- any by-products (***for e.g.***, renewable energy credits that are generated through the use of the asset), including potential cash flows derived from these items.
- benefits from using the asset that could be realised from a commercial transaction with a third party (***for e.g.***, subleasing the asset)

When assessing whether the customer has the right to obtain substantially all of the economic benefits from the use of an asset, an entity must consider the economic benefits that result from use of the asset within the **defined scope** of the customer's right to use the asset. A right that **solely protects** the supplier's interest in the underlying asset (***for e.g.***, limits on the number of miles a customer can drive a supplier's vehicle) does not, in and of itself, prevent the customer from obtaining substantially all of the economic benefits from use of the asset and, therefore, are **not considered** when assessing whether a customer has the right to obtain substantially all of the economic benefits.

If a contract requires a customer to pay the supplier or another party a portion of the cash flows derived from the use of an asset as consideration (***for e.g.***, if the customer is required to pay the supplier a percentage of sales from use of retail space as consideration for that use), that requirement does not prevent the customer from having the right to obtain substantially all of the economic benefits from use of the retail space. This is because the cash flows arising from those sales are considered to be economic benefits that the customer obtains from use of the retail space, a portion of which it then pays to the supplier as consideration for the right to use that space.

Illustration 8 (Right to obtain substantially all of the economic benefits):

Company MNO enters into a 15-year contract with Power Company PQR to purchase all of the electricity produced by a new solar farm. PQR owns the solar farm and will receive tax credits relating to the construction and ownership of the solar farm, and MNO will receive renewable energy credits that accrue from use of the solar farm.).

Who has the right to substantial benefits from the solar farm?

Solution:

Company MNO has the right to obtain substantially all of the economic benefits from use of the solar farm over the 15-year period because it obtains:

- the electricity produced by the farm over the lease term — i.e. the primary product from use of the asset; and
- the renewable energy credits — i.e. the by-product from use of the asset.

Although PQR receives economic benefits from the solar farm in the form of tax credits, these economic benefits relate to the ownership of the solar farm. The tax credits do not relate to use of the solar farm and therefore are not considered in this assessment.

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<u>Right to Direct the Use of the Identified Asset</u>

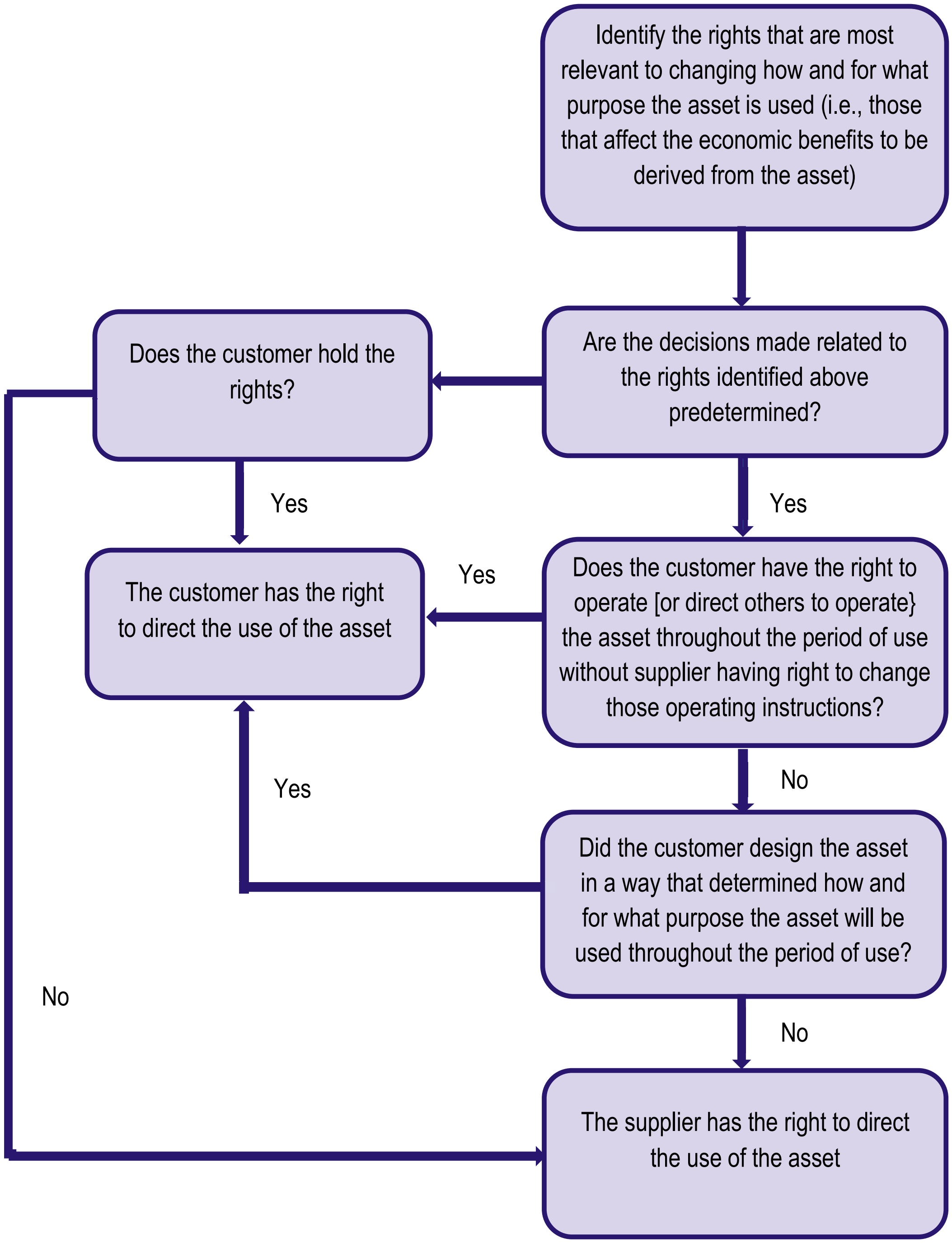
The second criterion in the control assessment is to determine whether the customer has the right to direct the use of the identified asset throughout the period of use.

Decisions about **<u>how and for what purpose an asset will be used</u>** are the most relevant factors to consider when assessing which party directs the use of the identified asset. Because such rights determine the economic benefits that can be derived from using the asset during the period of use.

Decisions regarding where and when the asset is to be used are likely to be more important than how those decisions are implemented. For example, if a customer outsources operation of an asset to an outside service provider, the outsourcing does not typically influence the economic benefits that can be derived from the asset.

In some arrangements, the decisions related to how and for what purpose an asset is used, are already specified in the contract before the lease term commences. These decisions will need to be considered in conjunction with decisions made during the period of use to properly identify the party that directs the assets' use. Simply specifying the output prior to the term does not, on its own, constitute the ability to direct the use.

The following figure illustrates the analysis that should be used to determine which party has the right to direct the use of an identified asset.



A customer has the right to direct the use of an identified asset whenever it has the right to direct **how and for what purpose** the asset is used throughout the period of use (i.e., it can **change** how and for what purpose the asset is used throughout the period of use). How and for what purpose an asset is used is a **SINGLE CONCEPT** (i.e., 'how' an asset is used is **not assessed separately** from 'for what purpose' an asset is used).

When evaluating whether a customer has the right to change how and for what purpose the asset is used throughout the period of use, the focus should be on whether the customer has the **decision-making rights that will most affect the economic benefits** that will be derived from the use of the asset. The decision-making rights that are most relevant are likely to depend on the nature of the asset and the terms and conditions of the contract.

Ind AS 116 provides the following examples of decision-making rights that grant the right to change how and for what purpose an asset is used:

Particulars	*Examples*
The right to change the type of output that is produced by the asset	(i) Deciding whether to use a shipping container to transport goods or for storage (ii) Deciding on the mix of products sold from a retail unit
The right to change when the output is produced	Deciding when an item of machinery or a power plant will be used
The right to change where the output is produced	(i) Deciding on the destination of a truck or a ship (ii) Deciding where a piece of equipment is used or deployed
The right to change whether the output is produced and the quantity of that output	Deciding whether to produce energy from a power plant and how much energy to produce from that power plant

Although **the decisions about maintaining and operating the asset** are often essential to the efficient use of that asset, the right to make those decisions, **in and by itself, does not result** in the right to change how and for what purpose the asset is used throughout the period of use.

The customer does **not need the right to operate** the underlying asset to have the right to direct its use, i.e., the customer may direct the use of an asset that is operated by the supplier's personnel. However, the right to operate an asset will often provide the customer the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used are predetermined.

The relevant decisions about how and for what purpose an asset is used are predetermined:

In some cases, it will not be clear whether the customer has the right to direct the use of the identified asset. This could be the case when

- the most relevant decisions about how and for what purpose an asset is used are **predetermined by contractual restrictions** on the use of the asset (***for e.g.***, the decisions about the use of the asset are agreed to by the customer and the supplier in negotiating the contract, and those decisions cannot be changed) ***OR***
- the most relevant decisions about how and for what purpose an asset is used are, in effect, **predetermined by the design of the asset**

In cases where the decisions about how and for what purpose an asset is used are predetermined, a customer has the right to direct the use of an identified asset throughout the period of use when the customer either:

- Has the **right to operate** the asset, ***OR*** **direct others to operate** the asset in a manner it determines, throughout the period of use without the supplier having the right to change those operating instructions ***OR***
- **Designed** the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

Significant judgement may be required to assess whether a customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

Specifying the output of an asset before the period of use
If a customer can only specify the output from an asset before the beginning of the period of use and cannot change that output throughout the period of use, the customer does **not have the right to direct the use of that asset unless** it designed the asset, ***OR*** specific aspects of the asset. If the customer did not design the asset or aspects of it, the customer's ability to specify the output in a contract that does not give it any other relevant decision-making rights relating to the use of the asset (***for e.g.***, the ability to change when, whether and what output is produced) gives the customer the same rights as any customer that purchases goods or services in an arrangement (i.e., a contract that does not contain a lease).

Protective rights
A supplier's protective rights, **in isolation, do not prevent the customer from having the right to direct the use** of an identified asset. Protective rights typically define the scope of the customer's right to use the asset without removing the customer's right to direct the use of the asset. Protective rights are intended to protect a supplier's interests (***for e.g.***, interests in the asset, its personnel, compliance with laws and regulations) and might take the form of a specified maximum amount of asset use, a restriction on where an asset may be used or a requirement to follow specific operating instructions.

Illustration 9 - Right to direct the use of an asset

Customer X enters into a contract with Supplier Y to use a vehicle for a five-year period. The vehicle is identified in the contract. Supplier Y cannot substitute another vehicle unless the specified vehicle is not operational (for e.g., if it breaks down). Under the contract:

- *Customer X operates the vehicle (i.e., drives the vehicle) or directs others to operate the vehicle (for e.g., hires a driver).*
- *Customer X decides how to use the vehicle (within contractual limitations). For example, throughout the period of use, Customer X decides where the vehicle goes, as well as when or whether it is used and what it is used for. Customer X can also change these decisions throughout the period of use.*
- *Supplier Y prohibits certain uses of the vehicle (for e.g., moving it overseas) and modifications to the vehicle to protect its interest in the asset.*

Whether Customer X has the right to direct the use of the vehicle throughout the period of lease?

Solution:

Yes, Customer X has the right to direct the use of the identified vehicle throughout the period of use because it has the **right to change** how the vehicle is used, when or whether the vehicle is used, where the vehicle goes and what the vehicle is used for.

Supplier Y's limits on certain uses for the vehicle and modifications to it are considered **protective rights** that define the scope of Customer X's use of the asset, but do not affect the assessment of whether Customer X directs the use of the asset.

*****

Illustration 10 - Right to direct the use of an asset

Entity A contracts with Supplier H to manufacture parts in a facility. Entity A designed the facility and provided its specifications. Supplier H owns the facility and the land. Entity A specifies how many parts it needs and when it needs the parts to be available. Supplier H operates the machinery and makes all operating decisions including how and when the parts are to be produced, as long as it meets the contractual requirements to deliver the specified number on the specified date. Assuming supplier H cannot substitute the facility and hence is an identified asset.

Which party has the right to control the use of the identified asset (i.e., equipment) during the period of use?

Solution:

Entity A does not direct the use of the asset that most significantly drives the economic benefits because Supplier H determines how and when the equipment is operated once the contract is signed. Therefore, Supplier H has the right to control the use of the identified asset during the period of use. Although Entity A stipulates the product to be provided and has input into the initial decisions regarding the use of the asset through its involvement in the design of the asset, it does not have decision making rights over how and for what purpose the asset will be used over the asset during the period of use. This arrangement is a supply agreement, not a lease.

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Illustration 11 - Right to direct the use of an asset

Entity L enters into a five—year contract with Company A, a ship owner, for the use of an identified ship. Entity L decides whether and what cargo will be transported, and when and to which ports the ship will sail throughout the period of use, subject to restrictions specified in the contract. These restrictions prevent Entity L from sailing the ship into waters at a high risk of piracy or carrying explosive materials as cargo. Company A operates and maintains the ship, and is responsible for safe passage.

Who has the right to direct the use of the ship during the period of use?

Solution:

Entity L has the right to direct the use of the ship. The contractual restrictions are protective rights. In the scope of its right of use, Entity L determines how and for what purpose the ship is used throughout the five — year period because it decides whether, where and when the ship sails, as well as the cargo that it will transport. Entity L has the right to change these decisions throughout the period of use. Therefore, the contract contains a lease.

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3.2.2 Separation of Lease and Non-Lease Components

3.2.2.1 Identifying and separating lease components of a contract

Sometimes, there are contracts that contain rights to use multiple assets (***for e.g.***, a building and an equipment, multiple pieces of equipment, etc.). The right to use each such asset is considered as a 'separate' lease component **ONLY IF BOTH** the following conditions are satisfied:

- The lessee can benefit from the use of the asset either on its own ***OR*** together with other resources that are readily available to the lessee (i.e., goods or services that are sold or leased separately, by the lessor or other suppliers, or that the lessee has already obtained from the lessor or in other transactions or events) ***AND***
- The underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract.

If one or both of these criteria are not met then, the right to use multiple assets is considered a 'single' lease component, i.e., not a 'separate' lease component. Let us have a look at the following illustration to have a better understanding:

Illustration 12 - Identifying and separating lease components

Scenario A:

*A lessee enters a lease of an excavator and the related accessories (**for e.g.**, excavator attachments) that are used for mining purposes. The lessee is a local mining company that intends to use the excavator at a copper mine. How many lease and non-lease components are there?*

Scenario B:

*Assume the same facts as in Scenario A, except that the contract also conveys the right to use an additional loading truck. This loading truck could be deployed by the lessee for other uses (**for e.g.**, to transport iron ores at another mine).*

Solution:

Scenario A:

The lessee would be unable to benefit from the use of the excavator without also using the accessories. Therefore, the excavator is dependent upon the accessories. Thus, from the perspective of the lessee, the contract contains one lease component.

Scenario B:

The lessee can benefit from the loading truck on its own or together with other readily available resources because the loading truck could be deployed for other uses independent of the excavator. The lessee can also benefit from the use of the excavator on its own or together with other readily available resources.

Thus, from the perspective of the lessee, the contract contains two lease components, viz., a lease of the excavator (together with the accessories) and a lease of the loading truck.

*****

3.2.2.2. Separating lease components from non-lease components:

There may be many contracts containing a lease coupled with an agreement to purchase or sell other goods or services (i.e., the non-lease components under Ind AS 116). For example, a supplier may lease a truck and also operate the leased asset on behalf of a customer (i.e., provide a driver). This service is not related to securing the use of the truck. Only items that contribute to securing the output of the asset are lease components. In this example, only the use of the truck is considered a lease component. Similarly, costs incurred by a supplier to provide maintenance on an underlying asset, as well as the materials and supplies consumed as a result of the use of the asset, are not lease components.

The non-lease components are identified and accounted for separately from the lease component in accordance with other standards. ***For e.g.***, the non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to Ind AS 115 by lessors (suppliers).

Costs related to property taxes and insurance do not involve the transfer of a good or service. Consequently, if these costs are fixed in the contract, they should be included in the overall contract consideration to be allocated to the lease and non-lease components.

Lessee reimbursements – whether a separate component of a contract?

As already discussed above that under Ind AS 116, payments for maintenance activities, including common area maintenance (***for e.g.***, cleaning the common areas of a building, removing snow from a car park for employees and customers) and other goods or services transferred to the lessee (***for e.g.***, providing utilities or rubbish removal) are considered as **non-lease components** because they provide the lessee with a service.

But, in some leases, a lessee also may **reimburse (or make certain payments on behalf of)** the lessor that relate to the leased asset for activities and costs that do not transfer a good or service to the lessee (***for e.g.***, payments made for real estate taxes that would be owed by the lessor regardless of whether it leased the building and regardless of who the lessee is).

Under Ind AS 116, such costs are **not separate components of the contract** because they do not represent payments for goods or services and are considered to be part of the total consideration that is allocated to the separately identified components of the contract (i.e., the lease and non-lease components, if any).

Illustration 13 - Identifying different components in the contract

Entity L rents an office building from Landlord M for a term of 10 years. The rental contract stipulates that the office is fully furnished and has a newly installed and tailored HVAC system. It also requires Landlord M to perform all common area maintenance (CAM) during the term of the arrangement. Entity L makes single monthly rental payment and does not pay for the maintenance separately. The office building has a useful life of 40 years and the HVAC system and office furniture each has a life of 15 years.

What are the units of account in the lease?

Solution:

There are three components in the arrangement – the building assets (office building and HVAC), the office furniture, and the maintenance agreement.

The office building and HVAC system are one lease component because they cannot function independently of each other. The HVAC system was designed and tailored specifically to be integrated into the office building and cannot be removed and used in another building without incurring substantial costs. These building assets are a lease component because they are identified assets for which Entity L directs the use.

The office furniture functions independently and can be used on its own. It is also a lease component because it is a group of distinct assets for which Entity L directs the use.

The maintenance agreement is a non-lease component because it is a contract for service and not for the use of a specified asset.

*****

Optional exemption of using Practical Expedient to not to separate non-lease component

Ind AS 116 provides a practical expedient that permits lessees to make an **accounting policy election**, by **CLASS OF UNDERLYING ASSET**, to account for each separate lease component of a contract and any associated non-lease components as a **SINGLE LEASE COMPONENT**. It is important to note the such practical expedient is not permissible for lessor.

Making this election relieves the lessee of the obligation to perform a pricing allocation, although it will increase the total lease liability to be recorded on its balance sheet. This expedient is not available for lessors. Lessees that make the **policy election** to account for each separate lease component of a contract and any associated non-lease components as a **SINGLE LEASE COMPONENT**, **allocate ALL of the contract consideration to the lease component**.

It is very important to note that the practical expedient does not allow lessees to account for multiple lease components of a contract as a single lease component, if it meets the conditions provided in Section 3.2.2.1.

3.2.2.3 Determining and allocating the consideration in the contract – Lessee

Lessees that do not make an accounting policy election (by class of underlying asset) to use the practical expedient, as discussed above, to account for each separate lease component of a contract and any associated non-lease components as a single lease component, are required to **allocate** the consideration in the contract to the lease and non-lease components on a **RELATIVE STAND-ALONE PRICE BASIS**.

Lessees are required to use **observable** stand-alone prices (i.e., prices at which a customer would purchase a component of a contract separately) when available. If observable stand-alone prices are not readily available, lessees **estimate** stand-alone prices, maximising the use of observable information.

Illustration 14 - Activities which are not components of a lease contract

Scenario A:

A lessee enters into a five-year lease of equipment, with fixed annual payments of ₹ 10,000. The contract contains fixed annual payments as follows: ₹ 8,000 for rent, ₹ 1,500 for maintenance and ₹ 500 of administrative tasks. How the consideration would be allocated?

Scenario B:

Assume the fact pattern as in scenario A except that, in addition, the contract requires the lessee to pay for the restoration of the equipment to its original condition. How the consideration would be allocated?

Solution:

Scenario A:

The contract contains two components, viz., a lease component (lease of equipment) and a non-lease component (maintenance). The amount paid for administrative tasks does not transfer a good or service to the lessee.

Assuming that the lessee does not elect to use the practical expedient as per para 15 of Ind AS 116, both the lessee and the lessor account for the lease of equipment and maintenance components separately and the administration charge is included in the total consideration to be allocated between those components. Therefore, the total consideration in the contract of ₹ 50,000 will be allocated to the lease component (equipment) and the non-lease component (maintenance).

Scenario B:

The contract still contains two components, viz., a lease component (lease of equipment) and a non-lease component (maintenance). Similar to the amount paid for administrative tasks, the restoration does not transfer a good or service to the lessee as it is only performed at the end of the lease term.

Therefore, the total consideration in the contract of ₹ 50,000 will be allocated to the lease component (equipment) and the non-lease component (maintenance).

*****

Illustration 15 - Allocating contract consideration to lease and non-lease components – Lessees

A lessee enters into a lease of an equipment. The contract stipulates the lessor will perform maintenance of the leased equipment and receive consideration for that maintenance service. The contract includes the following fixed prices for the lease and non-lease component:

Lease	*₹ 80,000*
Maintenance	*₹ 10,000*
Total	***₹ 90,000***
Assume the stand-alone prices cannot be readily observed, so the lessee makes estimates, maximising the use of observable information, of the lease and non-lease components, as follows:	
Lease	*₹ 85,000*
Maintenance	*₹ 15,000*
Total	***₹ 1,00,000***

In the given scenario, assuming lessee has not opted the practical expedient, how will the lessee allocate the consideration to lease and non-lease component?

Solution:

The stand-alone price for the lease component represents 85% (i.e., ₹ 85,000 / ₹ 1,00,000) of total estimated stand-alone prices. The lessee allocates the consideration in the contract (i.e., ₹ 90,000), as follows:	
Lease	* ₹ 76,500
Maintenance	** ₹ 13,500
Total	**₹ 90,000**
** ₹ 90,000 x 85%* *** ₹ 90,000 x 15%*	

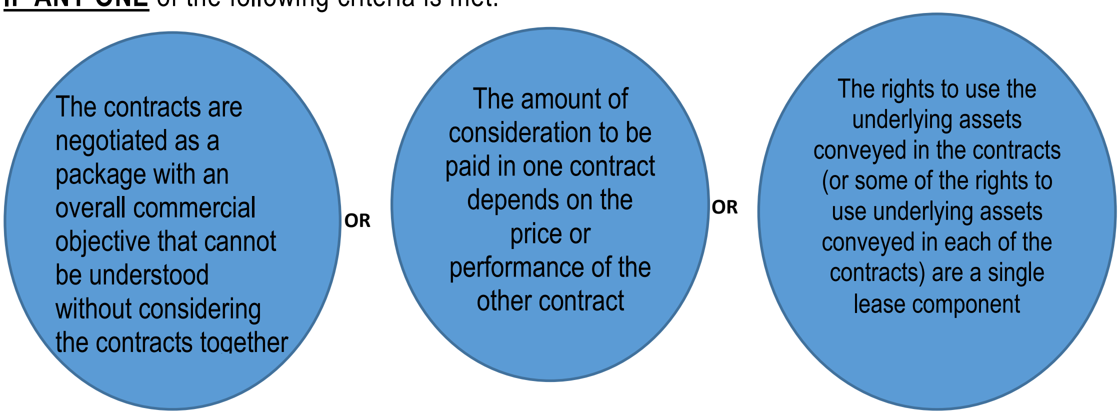
*****

3.2.2.4 Determining and allocating the consideration in the contract – Lessors:

Lessor are required to **allocate** the consideration in the contract to the lease and any associated non-lease components by applying the **paragraphs 73 – 90 of** Ind AS 115 *Revenue from Contracts with Customers.*

3.2.3 Contract Combinations

Ind AS 116 requires that two or more contracts entered into at or near the **same time** with the **same counterparty** (**or related parties of the counterparty**) be considered a **'single' contract IF ANY ONE** of the following criteria is met:



3.2.4 Portfolio Application

Ind AS 116 applies to individual leases. However, entities that have a large number of leases of similar assets (***for e.g.***, leases of a fleet of similar rolling stock) may face practical challenges in applying the leases model on a lease-by-lease basis.

Thus, Ind AS 116 includes a practical expedient that allows entities to use a portfolio approach for leases with similar characteristics if the entity reasonably expects that the effects on the financial statements would not differ materially from the application of the standard to the individual leases in that portfolio.

This approach is consistent with that under Ind AS 115. A decision to use the portfolio approach would be similar to a decision some entities make today to expense, rather capitalise, certain assets when the accounting difference is, and would continue to be, immaterial to the financial statements.

3.3 KEY CONCEPTS

3.3.1 Inception and Commencement of Lease

Ind AS 116 requires customers and suppliers to determine whether a contract is or contains a lease at the **inception** of the contract.

The **inception date** is defined as the *earlier* of the following dates:

- date of a lease agreement
- date of commitment by the parties to the principal terms and conditions of the lease

The **commencement date** is defined as the date on which a lessor makes an underlying **asset available for use** by a lessee. Where, the 'underlying asset' is an asset that is the subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee.

In certain cases, the commencement date of the lease may be before the date stipulated in the lease agreement (***for e.g.***, the date on which rents become due and payable). This often occurs when the leased space is modified by the lessee prior to commencing operations in the leased space (***for e.g.***, during the period a lessee uses the leased space to construct its own leasehold improvements).

If a lessee takes possession of, or is given control over, the use of the underlying asset **before** it begins operations or making lease payments under the terms of the lease, **the lease term has commenced even if** the lessee is not required to pay rent or the lease arrangement states the lease commencement date is a later date.

The timing of when lease payments begin under the contract **does not affect** the commencement date of the lease.

As discussed earlier, **inception date** is the date when an entity shall **assess** if the contract is or contains lease. While the **commencement date** is relevant because on that date**:**

(i) a lessee (except where the exemption of short-term lease or low-value asset is taken) **initially recognises a lease liability** and related Right of Use Asset (hereinafter referred to as "ROU Asset") on the commencement date

(ii) a lessor (for finance leases) initially recognises its net investment in the lease on the commencement date.

Where, **<u>'ROU Asset'</u>** is defined as an asset that represents a lessee's right to use an **underlying asset** for the **lease term**.

3.3.2 Lease Term

Determination of lease term is a very crucial step before the calculation of the Lease Liability and the corresponding ROU Asset. In simple terms, lease term is the **<u>summation</u>** of the following:

NON-CANCELLABLE PERIOD + Periods covered by an option to **EXTEND** the lease if the lessee is reasonably certain **TO** exercise that option + Periods covered by an option to **TERMINATE** the lease if the lessee is reasonably certain **NOT TO** exercise that option

The lease term begins at the lease **<u>commencement date</u>**. The lease term starts when the lessor makes the underlying asset available for use by the lessee and includes any rent free periods provided.

The assessment of whether it is reasonably certain that a lessee will exercise an extension or termination option **<u>should be done on lease commencement date.</u>** An entity should consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise, or not to exercise, the option, including any expected changes in facts and circumstances from the commencement date until the exercise date of the option. The assessment should not be based solely on the lessee's intentions, past practices, or estimates. It should focus on the factors that create an economic incentive for the lessee, including contract-, asset-, entity-, or market-based factors. Example of relevant factors to consider are:

<u>Contractual terms vis-a vis market rates</u>	**<u>Asset related factors</u>**
1. Lease rentals in optional period, ex. Termination penalties and residual value guarantees	1. Specialised asset
2. Variable or contingent payment	2. Location of underlying asset
3. Terms and condition after initial optional period, ex. Purchase option	3. Availability of suitable alternatives
4. Cost relating to the termination of the lease and signing of new replacement lease	4. Existence of significant leasehold improvement

In certain cases, it can be more difficult to determine whether the exercise of the option is reasonably certain where the period from the commencement of the lease to the exercise date of an option, is longer. The said difficulty arises from several factors. ***For e.g.***, a lessee's estimates of its future needs for the leased asset become less precise the further into the future the forecast goes. Also, the future fair value of certain assets such as those involving technology is more difficult to predict than the future fair value of a relatively stable asset, such as a fully leased commercial office building located in a prime area.

An artificially short lease term (***for e.g.***, a lease of a corporate headquarters, distribution facility, manufacturing plant or other key property with a four-year lease term), may effectively create a significant economic incentive for the lessee to exercise a purchase or renewal option. This may be evidenced by the significance of the underlying asset to the lessee's continuing operations and whether, absent the option, the lessee would have entered into such a lease.

Similarly, the significance of the underlying asset to the lessee's operations may affect a lessee's decisions about whether it is reasonably certain to exercise a purchase or renewal option. ***For e.g.***, a company that leases a specialised facility (e.g., manufacturing plant, distribution facility, corporate headquarters) and does not exercise a purchase or renewal option would face a significant economic penalty if an alternative facility is not readily available. This would potentially have an adverse effect on the company while it searched for a replacement asset.

An option to extend or terminate a lease may be combined with one or more other contractual features (for example, a residual value guarantee) such that the lessee guarantees the lessor a minimum or fixed cash return that is substantially the same regardless of whether the option is exercised. In such cases, and notwithstanding the guidance on in-substance fixed payments, an entity shall assume that the lessee is reasonably certain to exercise the option to extend the lease, or not to exercise the option to terminate the lease.

The shorter the non-cancellable period of a lease, the more likely a lessee is to exercise an option to extend the lease or not to exercise an option to terminate the lease. This is because the costs associated with obtaining a replacement asset are likely to be proportionately higher the shorter the non-cancellable period.

A lessee's past practice regarding the period over which it has typically used particular types of assets (whether leased or owned), and its economic reasons for doing so, may provide information that is helpful in assessing whether the lessee is reasonably certain to exercise, or not to exercise, an option. For example, if a lessee has typically used particular types of assets for a particular period of time or if the lessee has a practice of frequently exercising options on leases of particular types of underlying assets, the lessee shall consider the economic reasons for that past practice in assessing whether it is reasonably certain to exercise an option on leases of those assets.

A lessee may enter into a lease contract for non-consecutive periods. This is seen in the retail industry when retailers enter into contracts with shopping centers to lease the same retail space for certain non-consecutive months of the year (e.g., during an annual holiday period). Similar arrangements also exist when sports teams lease a sports stadium for particular non-consecutive days of the year. These arrangements will usually meet the definition of a lease because during the agreed period of use, the customer controls the right to use the underlying asset. In these arrangements, the lease term is the aggregate of the non-consecutive periods.

Illustration 16 - Determining the lease term

Scenario A:

Entity ABC enters into a lease for equipment that includes a non-cancellable term of six years and a two-year fixed-priced renewal option with future lease payments that are intended to approximate market rates at lease inception. There are no termination penalties or other factors indicating that Entity ABC is reasonably certain to exercise the renewal option. What is the lease term?

Scenario B:

Entity XYZ enters into a lease for a building that includes a non-cancellable term of eight years and a two-year, market-priced renewal option. Before it takes possession of the building, Entity XYZ pays for leasehold improvements. The leasehold improvements are expected to have significant value at the end of eight years, and that value can only be realised through continued occupancy of the leased property. What is the lease term?

Scenario C:

Entity PQR enters into a lease for an identified retail space in a shopping centre. The retail space will be available to Entity PQR for only the months of October, November and December during a non-cancellable term of seven years. The lessor agrees to provide the same retail space for each of the seven years. What is the lease term?

Solution:

Scenario A:

At the lease commencement date, the lease term is six years (being the non-cancellable period). The renewal period of two years is not taken into consideration since it is mentioned that Entity ABC is not reasonably certain to exercise the option.

Scenario B:

At the lease commencement, Entity XYZ determines that it is reasonably certain to exercise the renewal option because it would suffer a significant economic penalty if it abandoned the leasehold improvements at the end of the initial non-cancellable period of eight years. Thus, at the lease commencement, Entity XYZ concludes that the lease term is ten years (being eight years of non-cancellable period plus the renewal period of two years where the lessee is reasonably certain to exercise the option).

Scenario C:

At the lease commencement date, the lease term is 21 months (three months per year over the seven annual periods as specified in the contract), i.e., the period over which Entity PQR controls the right to use the underlying asset.

*****

Cancellable leases:

In determining the lease term and assessing the length of the non-cancellable period of a lease, an entity shall apply the definition of a contract and determine the period for which the contract is enforceable. A 'contract' is defined as an agreement between two or more parties that creates enforceable rights and obligations.

An arrangement is **not enforceable** if:

(i) *both the lessor and lessee each have the right to terminate the lease without permission from the other party;* **AND**

(ii) *with no more than an insignificant penalty*

Any non-cancellable periods (by the lessee and the lessor) in contracts that meet the definition of a lease are considered part of the lease term. If only the lessor has the right to terminate a lease, the period covered by the option to terminate the lease is included in the non-cancellable period of the lease. If only the lessee has the right to terminate a lease, that right is a termination option that is considered when determining the lease term.

Ind AS 116 defines a 'contract' as an agreement between two or more parties that creates enforceable rights and obligations. Thus, Ind AS 116 applies to contracts that are referred to as 'cancellable', month-to-month', 'at will', 'evergreen', 'perpetual' or 'rolling' if they create enforceable rights and obligations. These types of lease generally allow for the contract to continue beyond a non-cancellable period until one party gives notice to terminate the contract (***for e.g.***, the contract will roll monthly until the lessee or the lessor elect to terminate the contract). If both the lessee and the lessor can terminate the contract without more than an insignificant penalty at any time at or after the end of the non-cancellable term, then there are no enforceable rights and obligations beyond the non-cancellable term (i.e., the lease term is limited to the non-cancellable term). However, if only the lessee holds a renewal option, there may be other factors to consider determining whether the lessee is reasonably certain to extend the lease, including economic disincentives (as discussed above).

This can be understood better with the help of the following illustrative situation:

Suppose the term of a contract is 10 years and the non-cancellable / lock-in period is 6 years. The lease term shall be as follows:

If the termination option is with 'Lessor'	If the termination option is with 'Lessee'	If the termination option is with 'Both' (i.e., any party can terminate)
The lease term shall be **<u>10 years</u>**. *Because even after 6^{th} year, the lessee would be contractually bound until 10^{th} Year i.e. lessee cannot refuse to make the payment till the expiry of the contract and also, has the right to use the asset until 10^{th} year, unless lessor terminates the contract.*	The lease term shall be **<u>10 years</u>** assuming reasonable certainty. *Because after the expiry of 6^{th} year, though the lessee is not contractually bound till 10^{th} year, i.e., the lessee can refuse to make payment anytime without lessor's permission but, it is assumed that the lessee is reasonably certain that it will not exercise this option to terminate. Hence, though there is no enforceable obligation from lessee's point of view beyond 6^{th} year but, basis the said assumption, the lease term shall be 10 years.*	The lease term shall be **<u>6 years</u>**. *Because after 6^{th} year, either party can terminate the contract without the consent of the other party and hence, the contract is not enforceable after 6^{th} year <u>ONLY</u> in case there is insignificant penalty for termination.*

<u>Reassessment of lease term and purchase options (for lessees):</u>

After the lease commencement, Ind AS 116 requires lessees to monitor leases for **<u>significant changes</u>** that could trigger a change in the lease term. Lessees are required to **<u>reassess</u>** the lease term upon the occurrence of either a **<u>significant event</u>** ***OR*** a **<u>significant change</u>** in the circumstances that:

Is within the control of the lessee

+

Affects whether the lessee is reasonably certain to exercise / not to exercise renewal, termination and/or purchase option, not previously included in its determination of the lease term

Following are some of the examples of significant events or significant changes in circumstances within the lessee's control:

1) Constructing significant leasehold improvements that are expected to have significant economic value for the lessee when the option becomes exercisable

2) Making significant modifications or customisations to the underlying asset

3) Making a business decision that is directly relevant to the lessee's ability to exercise, or not to exercise, an option (e.g., extending the lease of a complementary asset or disposing of an alternative asset)

4) Subleasing the underlying asset for a period beyond the exercise date of the option

Changes in market-based factors (***for e.g.***, a change in market rates to lease or purchase a comparable asset) are not within the lessee's control, and therefore, they **do not trigger a reassessment by themselves**.

Ind AS 116 also requires lessees to revise the lease term if there is change in the non-cancellable period of lease. Following are the example which leads to change in non-cancellable period of a lease:

Change in non-cancellable lease period

- If the lessee **exercises an option** not previously included in the entity's determination of the lease term
- If the lessee **does not exercise an option** previously included in the entity's determination of the lease term;
- An event occurs that **contractually obliges the lessee** to exercise an option not previously included in the entity's determination of the lease term
- An event occurs that **contractually prohibits** the lessee from exercising an option previously included in the entity's determination of the lease term.

As the lessee is required to reassess the lease term upon the occurrence of either a significant event or a significant change in the circumstances that is within the control of the lessee, the revision of the lease term often happens before the actual exercise of the option in these circumstances.

Illustration 17 - Re-assessment of exercise of lease extension option

Retailer M enters into a five-year lease for a building floor, followed by two successive five-year renewal options. On the commencement date, Retailer M is not reasonably certain to exercise the extension option. At the end of third year, Retailer M extended to include another floor from year 4 due to a business acquisition. For this purpose, the lessee concludes a separate seven-year lease for an additional floor in the building already leased. Is Retailer M required to reassess the lease term in this case?

Solution:

Ind AS 116 requires a lessee to reassess the lease term if there is change in business decision of the company which is directly relevant to exercising or not exercising an option to renew / extend the lease. In the given case, the Retailer M at the end of third year has extended to include another floor in the same building on account of acquiring another company. As Retailer M has entered into fresh lease of another floor for a seven-year term, it is reasonably certain to exercise the renewal option of original lease for a further five-year term. Hence Retailer M will have to reassess the lease term at the end of third year.

*****

Illustration 18 - Re-assessment of non-cancellable period of lease

Company N has taken 10 vehicles on lease for an initial period of 5 years with an extension option at the option of the lessee for a further period of 5 years at the same rental amount. The remaining useful life of the vehicles as on the commencement date of the lease is 15 years. Company N has determined at the commencement date that it is reasonably certain to exercise the extension option and hence it has taken a period of 10 years for the lease. At the end of 4th year, there is an announcement by the government that all the cars of this particular model have to be discontinued from the road within 1 year due to the change in the pollution norms in the country. Will the lease term be reassessed in this case?

Solution:

In the given case, as per Ind AS 116, the announcement by the government to discontinue the use of the underlying asset will prohibit the lessee from exercising the extension option that was already included in the non-cancellable period by Company N and hence, Company N will reassess the non-cancellable period to exclude the extension option of 5 years.

*****

Reassessment of lease term and purchase options (for lessors):

Ind AS 116 requires the lessor to revise the lease term to account for the lessee's exercise of an option to extend or terminate the lease or purchase the underlying asset, when exercise of such options was not already included in the lease term.

3.3.3 LEASE PAYMENTS

Lease payments are defined as payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following:

(a) fixed payments (including in-substance fixed payments), **less** any lease incentives

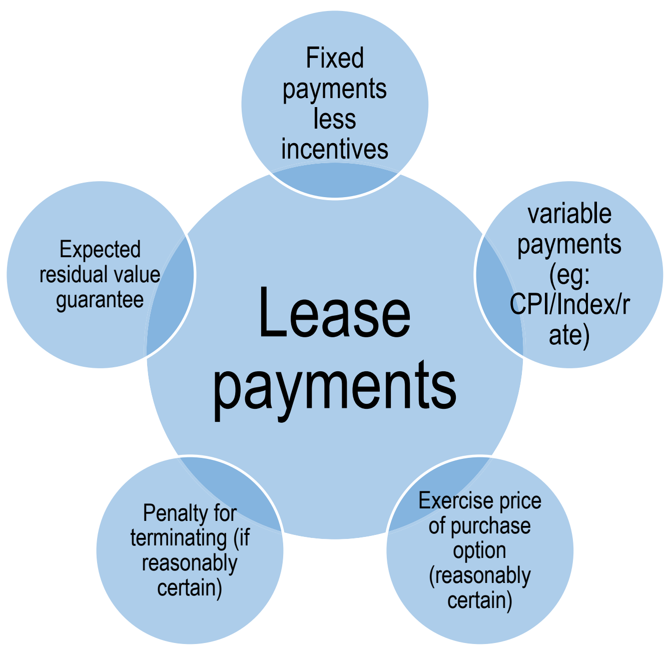
(b) variable lease payments that depend on an index or a rate

(c) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option

(d) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease

For the lessee, lease payments also include amounts expected to be payable by the lessee under residual value guarantees.

For the lessors, lease payment instead includes residual value guarantees provided by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.



Exclusion of payments for calculating lease liability:

a. Lease payments do not include payments allocated to non-lease components of a contract, unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component.

b. Variable lease payments that do not depend on index or rate.

3.3.3.1 Fixed lease payments

'Fixed payments' are defined as payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** during the **lease term**, excluding **variable lease payments**.

Fixed payments can either be a fixed amount paid at various intervals in a lease (e.g., a five-year equipment lease with annual lease payments of ₹ 20,000) or they can be payments that change over time (e.g., lease payments of ₹ 20,000 per month at lease commencement that increase annually by ₹ 2,500 per month).

Illustration 19 - Determining the fixed payments

Entity M and Lessor A enter into a 10-year lease of an office building for fixed annual lease payments of ₹ 200,000. Per the terms of the lease agreement, annual fixed lease payments comprise ₹ 170,000 for rent and ₹ 30,000 for real estate taxes.

What are the fixed lease payments for purposes of classifying the lease?

Solution:

The fixed lease payments are ₹ 2,00,000. Although real estate taxes are explicitly stated in the lease contract, they do not represent a separate non-lease component as they do not provide a separate good or service. The right to use the office building is the only component. The annual lease payments of ₹ 2,00,000 represent payments related to that single lease component.

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In-substance fixed lease payments:

As mentioned above, lease payments also include any in-substance fixed lease payments which are the payments that may, **in form**, contain variability but that, **in substance**, are unavoidable. Examples may include:

(a) if payments are structured as variable lease payments, but there is no genuine variability in those payments. Those payments contain variable clauses that do not have real economic substance.

Examples of those types of payments include:

- payments that must be made only if an asset is proven to be capable of operating during the lease, or only if an event occurs that has no genuine possibility of not occurring; ***OR***
- payments that are initially structured as variable lease payments linked to the use of the underlying asset but for which the variability will be resolved at some point after the

commencement date so that the payments become fixed for the remainder of the lease term. Those payments become in-substance fixed payments when the variability is resolved.

(b) if there is more than one set of payments that a lessee could make, but only one of those sets of payments is realistic. In such a case, an entity shall consider the realistic set of payments to be lease payments.

(c) if there is more than one realistic set of payments that a lessee could make, but it must make at least one of those sets of payments. In such a case, an entity shall consider the set of payments that aggregates to the lowest amount (on a discounted basis) to be lease payments.

Illustration 20 - In substance fixed lease payments

Entity Q enters into a seven-year lease for a piece of machinery. The contract sets out the lease payments as follows.

– *If Q uses the machinery within a given month, then an amount of 2,000 accrues for that month.*

– *If Q does not use the machinery within a given month, then an amount of 1,000 accrues for that month.*

What is considered as lease payment in this case?

Solution:

Q considers the contract and notes that although the lease payments contain variability based on usage, and there is a realistic possibility that Q may not use the machinery in some months, a monthly payment of 1,000 is unavoidable. Accordingly, this is an in-substance fixed payment, and is included in the measurement of the lease liability.

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Illustration 21 - In-substance fixed lease payment

Entity P enters into a five-year lease for office space with Entity Q. The initial base rent is ₹ 1 lakh per month. Rents increase by the greater of 1% of Entity P's generated sales or 2% of the previous rental rate on each anniversary of the lease commencement date. What are the lease payments for purposes of measuring lease liability?

Solution:

In the given case, the lease payments for purposes of classifying the lease are the fixed monthly payments of ₹ 1 lakh plus the minimum annual increase of 2% of the previous rental rate. Entity P is required to pay no less than a 2% increase regardless of the level of sales activity; therefore, this minimum level of increase is in substance fixed lease payment.

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Illustration 22 - In substance fixed lease payments

Company N leases a production line. The lease payments depends on the number of operating hours of the production line – i.e., N has to pay ₹ 1,000 per hour of use. The annual minimum payment is ₹ 10,00,000. The expected usage per year is 1,500 hours

Solution:

The lease contains in substance fixed payments of ₹ 10,00,000 per year, which are included in the initial measurement of the lease liability. The additional ₹ 5,00,000 that Company N expects to pay per year are variable payments that do not depend on an index or a rate but usage.

*****

Lease incentives

'Lease incentives' is defined as payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee.

A lease agreement with a lessor might include incentives for the lessee to sign the lease, such as an upfront cash payment to the lessee, payment of costs for the lessee (such as moving / transportation expenses) or the assumption by the lessor of the lessee's pre-existing lease with a third party.

For lessee, lease incentives that are paid or payable to lessee by the lessor are deductible from lease payments and reduce the initial measurement of lessee' ROU asset.

For lessors, lease incentives are also deducted from lease payments and affect the lease classification test. For finance leases, lease incentives that are payable to the lessee reduce the expected lease receivables at the commencement date and thereby the initial measurement of the lessor's net investment in the lease. Consequently, the selling profit or loss is not affected. For operating leases, lessors should defer the cost of any lease incentives paid or payable to the lessee and recognise that cost as a reduction to lease income over the lease term.

Lessor reimbursement for some (or all) of the costs a lessee incurs to complete leasehold improvements is a common example of a lease incentive. To determine whether a payment from the lessor to the lessee represents a lease incentive, a reporting entity should evaluate the nature of the improvement and determine whether it represents an asset for lessee or a lessor. If an improvement represents an asset for lessee, the lessor payment is a lease incentive that should be recorded as a reduction to fixed lease payments. On the other hand, reimbursement for an improvement that is an asset for lessor is not a lease incentive; it should be recorded as a reimbursement to the lessee for the cost of the asset of lessor.

3.3.3.2 Variable lease payments that depend on an index or a rate:

'Variable lease payments' are defined as the portion of payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** during the **lease term** that varies because of changes in facts or circumstances occurring after the **commencement date**, other than the passage of time.

These may include, ***for e.g.***, payments linked to a consumer price index, payments linked to a benchmark interest rate (such as LIBOR) or payments that vary to reflect changes in market rental rates. Such payments are **included** in the lease payments and are measured using the prevailing index or rate at the measurement date (e.g., lease commencement date for initial measurement).

Despite the measurement uncertainty associated with changes to index- or rate-based payments, the payments meet the definition of an asset (for lessor) and a liability (for lessee) because they are **unavoidable** and **do not depend on any future activity** of the lessee. Lessees subsequently remeasure the lease liability if there is a change in the cash flows (i.e., when the adjustment to the lease payments takes effect) for future payments resulting from a change in index or rate used to determine lease payments.

Illustration 23 - Variable lease payments that depend on an index or rate

An entity enters into a 10-year lease of property. The lease payment for the first year is ₹ 1,000. The lease payments are linked to the consumer price index (CPI), i.e., not a floating interest rate. The CPI at the beginning of the first year is 100. Lease payments are updated at the end of every second year. At the end of year one, the CPI is 105. At the end of year two, the CPI is 108. What should be included in lease payments?

Solution:

At the lease commencement date, the lease payments are ₹ 1,000 per year for 10 years. The entity does not take into consideration the potential future changes in the index. At the end of year one, the payments have not changed and hence, the liability is not updated.

At the end of year two, when the lease payments change, the entity updates the remaining eight lease payments to ₹ 1,080 per year (i.e., ₹ 1,000 / 100 x 108).

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Variable lease payments that do not depend on an index or a rate:

Variable lease payments that do not depend on an index or rate and are **not, in substance, fixed** (as discussed above – In-substance fixed lease payments). Examples may include payments such as those based on performance (***for e.g.***, a percentage of sales) or usage of the underlying asset (***for e.g.***, the number of hours flown, the number of units produced), are **not included** as lease payments. Instead, they are recognised in profit or loss in the period in which the event that triggers the payment occurs (unless they are included in the carrying amount of another asset in accordance with other Ind AS).

In some cases, the variability may be resolved during the lease term, so that payments become fixed for the remainder of the lease term. The new fixed payments are then used to remeasure the lease liability (with an offset to the ROU Asset).

When variable payments not included in consideration in the contract are recognized, lessees also allocate these amounts between lease and non-lease components on the same basis as the allocation of consideration in the contract. These payments include variable payments not based on an index or rate or the changes in variable payments based on an index or rate after the commencement date of the lease.

Illustration 24 - Variable lease payments that do not depend on an index or rate

Entity XYZ is a medical equipment manufacturer and a supplier of the related consumables. Customer ABC operates a medical centre. Under the agreement entered into by both parties, Entity XYZ grants Customer ABC the right to use a medical laboratory machine at no cost and Customer ABC purchases consumables for use in the equipment from Entity XYZ at ₹ 100 each.

The consumables can only be used for that equipment and Customer ABC cannot use other consumables as substitutes. There is no minimum purchase amount required in the contract.

Based on its historical experience, Customer ABC estimates that it is highly likely to purchase at least 8,000 units of consumables annually. Customer ABC has appropriately assessed that the arrangement contains a lease of medical equipment. There are no residual value guarantees or other forms of consideration included in the contract. Whether these payments affect the calculation of lease liability and ROU Asset? How does Entity XYZ and Customer ABC would allocate these lease payments?

Solution:

There are two components in the arrangement, viz., a lease of equipment and the purchase of consumables.

Even though Customer ABC may believe that it is highly unlikely to purchase lesser than 8,000 units of consumables every year, in this example, there are no lease payments for purposes of initial measurement (for Entity XYZ and Customer ABC) and lease classification (for Entity XYZ).

Entity XYZ and Customer ABC would allocate the payments associated with the future payments to the lease and consumables component of the contract.

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Illustration 25 - Variable lease payments

Entity A enters into a five-year lease of an office building. The lease payments are ₹ 5,00,000 per year and the contract includes an additional water charge calculated as ₹ 0.50 per litre consumed. Payments are due at the end of year. Entity A elects to apply the practical expedient to combine lease and non-lease components

Solution:

As stated above, payments are due at the end of the year. Entity A elects to apply the practical expedient not to separate lease and non-lease components.

At the commencement date, Entity A measures the lease liability as the present value of the fixed lease payments (i.e. five annual payments of 5,00,000). Although Entity A has elected to apply the practical expedient to combine non-lease components (i.e. water charges) with the lease component, Entity A excludes the non-lease component from its lease liability because they are variable payments that depend on usage. That is, the nature of the costs does not become fixed just because Entity A has elected not to separate them from the fixed lease payments. Entity A recognises the payments for water – as a variable lease payment – in profit or loss when they are incurred.

In contrast, if B does not elect to apply the practical expedient to combine lease and non-lease components, then it recognises the payments for water – as an operating expense – in profit or loss when they are incurred.

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3.3.3.3 Exercise price of a purchase option

If the lessee is **reasonably certain** to exercise a purchase option, the exercise price is **included** as a lease payment, i.e., entities consider the exercise price of asset purchase options included in lease contracts consistently with the evaluation of lease renewal and termination options (as discussed earlier).

3.3.3.4. Penalties for terminating a lease

If it is **reasonably certain** that the lessee will not terminate a lease, the lease term is determined assuming that the termination option would not be exercised, and any termination penalty is **excluded** from the lease payments. **Otherwise**, the lease termination penalty is **included** as a lease payment. The determination of whether to include lease termination penalties as lease payments is similar to the evaluation of lease renewal options (as discussed earlier).

3.3.3.5. Residual value guarantees (lessees):

'Residual value guarantee' is defined as a guarantee made to a **lessor** by a party unrelated to the lessor that the value (or part of the value) of an **underlying asset** at the end of a **lease** will be at least a specified amount.

For a lessee, lease payments include amounts expected to be **payable by the lessee** under residual value guarantees. A lessee may provide a guarantee to the lessor that the value of the underlying asset it returns to the lessor at the end of the lease will be at least of a specified amount. Such guarantees are enforceable obligations that the lessee has assumed by entering into the lease. A lessee is required to remeasure the lease liability if there is a change in the amounts expected to be payable under a residual value guarantee.

Illustration 26 - Residual value guarantee included in lease payments

An entity (a lessee) enters into a lease and guarantees that the lessor will realise ₹ 20,000 from selling the asset to another party at the end of the lease. At lease commencement, based on the lessee's estimate of the residual value of the underlying asset, the lessee determines that it expects that it will owe ₹ 8,000 at the end of the lease. Whether the lessee should include the said payment of ₹ 8,000 as a lease payment?

Solution:

The lessee should include the amount of ₹ 8,000 as a lease payment because it is expected that it will owe the same to the lessor under the residual value guarantee.

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Residual value guarantees (lessors):

Ind AS 116 requires lessors to **include** in the lease payments, any residual value guarantees provided to the lessor by the lessee, a party related to the lessee, or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee. This amount included in the lease payments is **different** from that for a lessee which only includes the amount expected to be payable by lessee only (as discussed above).

3.3.4 Lessee Involvement before Commencement Date

An entity may negotiate a lease before the underlying asset is available for use by the lessee. For some leases, the underlying asset may need to be constructed or redesigned for use by the lessee. Thus, based on the terms and conditions of the contract, a lessee may be required to make payments relating to the construction or design of the asset.

Costs relating to the construction or design of an underlying asset do not include payments made by the lessee for the right to use the underlying asset since, payments for the right to use an underlying asset are the payments for a lease, regardless of the timing of those payments. Thus, if the lessee incurs such costs, they are accounted by applying other Ind AS (such as Ind AS 16, Property, Plant and Equipment).

The lessee may obtain legal title to an underlying asset before that legal title is transferred to the lessor and the asset is leased to the lessee. Obtaining legal title does not in itself determine how to account for the transaction. If the lessee controls (or obtains control of) the underlying asset before that asset is transferred to the lessor, the transaction is a 'sale and leaseback transaction' (Please refer Section 3.6.2 'Sale and Leaseback Transactions' for further discussion)

However, if the lessee does not obtain control of the underlying asset before the asset is transferred to the lessor, the transaction is not a 'sale and leaseback transaction'. ***For e.g.***, this may be the case if a manufacturer, a lessor and a lessee negotiate a transaction for the purchase of an asset from the manufacturer by the lessor, which is in turn leased to the lessee. The lessee may obtain legal title to the underlying asset before legal title transfers to the lessor. In this case, if the lessee obtains legal title to the underlying asset, but does not obtain control of the asset before it is transferred to the lessor, the transaction is not accounted for as a sale and leaseback transaction, but it is rather accounted as a lease.

3.3.5 Initial Direct Costs

'Initial direct costs' are defined as **<u>the incremental costs of obtaining a lease</u>** that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease.

Examples of costs included and excluded from initial direct costs is provided below.

Included	Excluded
Commission (including payments to employees acting as selling agents)	Employee salaries
Legal fees resulting from the execution of the lease	Legal fees for services rendered before the execution of the lease
Lease document preparation costs incurred after the execution of the lease	Negotiating lease term and conditions
Certain payments to existing tenants to move out	Advertising
Consideration paid for a guarantee of a residual asset by an unrelated third party	Depreciation and amortization

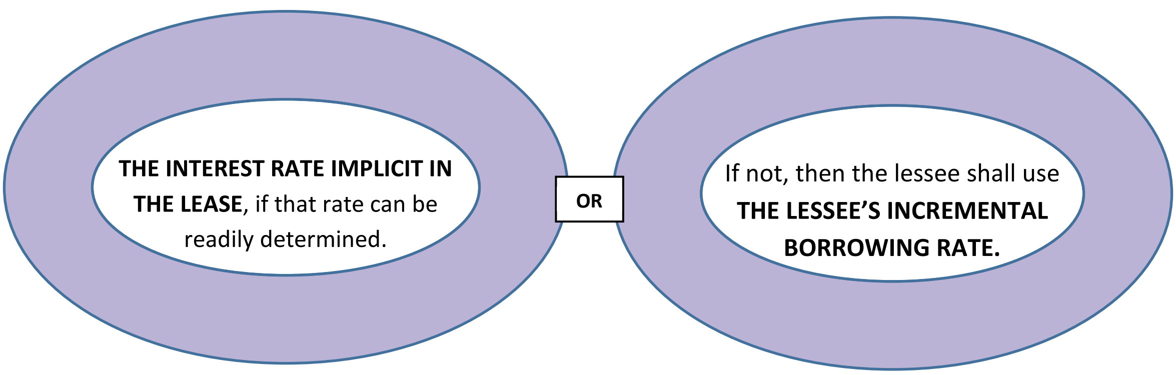
Lessees and lessors apply the same definition of initial direct costs. The requirements under Ind AS 116 for initial direct costs are consistent with the concept of incremental costs in Ind AS 115, Revenue from Contracts with Customers.

3.3.6 Discount Rates

Discount rates are used to determine the present value of the lease payments, which are used to determine Right of Use asset and Lease liability in case of a lessee and to measure a lessor's net investment in the lease.

<u>For a Lessee</u>

As per Ind AS 116, the Discount Rate to be used should be:



Where,

<u>'Interest rate implicit in the lease'</u> is defined as the rate of interest that causes the following:

The present value of lease payments made by the lessee for the right to use the underlying asset	+	The unguaranteed residual value	=	The fair value of the underlying asset	+	Any initial direct costs of the lessor

Lease payments are discounted using the interest rate implicit in the lease (as above and to be calculated from the perspective of lessor) if that rate can be readily determined. But, if that rate cannot be readily determined then, the lessee uses the incremental borrowing rate.

As discussed above, the lessee's **<u>incremental borrowing rate</u>** is the rate of interest that

- the lessee would have to pay to borrow over a **<u>similar term</u>**,
- and with a **<u>similar security</u>**,
- the funds necessary to obtain an asset of a **<u>similar value</u>** to the Right of use Asset
- in a **<u>similar economic environment</u>**.

In determining the incremental borrowing rate, the lessee considers borrowings with a similar term and security to the ROU Asset (**<u>NOT the underlying asset</u>**). ***For e.g.***, in the case of a five-year property lease, the lessee considers the borrowings with a similar term to the five-year ROU Asset (and NOT the property itself), which may have a significantly longer life. Observable rates (such as a property yield) can be used as a **<u>starting point</u>** to determine the incremental borrowing rate but adjustments need to be considered for an asset with a value similar to the ROU Asset. Other potential sources of adjustment may include the credit profile of the lessee, the borrowing currency, or the length of the lease term. It is likely that, in some cases, **<u>significant judgement</u>** will be needed to determine the incremental borrowing rate.

As discussed above, the lessee's incremental borrowing rate reflects the rate of interest that a lessee would have to pay, among others, in a similar economic environment. If the contract requires lease payments to be made in a currency other than the functional currency of the lessee (i.e., payments are to be made in a foreign currency) then, the incremental borrowing rate of the lessee should be determined based on a borrowing of a similar amount in that foreign currency.

<u>For a Lessor:</u>

Lessor to use the interest rate implicit in the lease as discussed above.

3.3.7 Economic Life

'Economic Life' is defined as either

- the period over which an asset is expected to be economically usable by one or more users or
- the number of production or similar units expected to be obtained from an asset by one or more users.

3.4 LESSEE ACCOUNTING

3.4.1 Initial Recognition and Measurement

A **'lessee'** is defined as an entity that obtains the right to use an **underlying asset** for a period of time in exchange for consideration.

At the commencement date, a lessee shall recognise a ROU Asset and a Lease Liability. Ind AS 116 requires lessees to recognise a liability to make lease payments and an asset representing the right to use the underlying asset (i.e., the ROU Asset) during the lease term for ***ALL*** leases (**except** for short-term leases and leases of low-value assets, if they choose to apply such exemptions).

Measuring the lease liability:

At the commencement date, a lessee initially measures the Lease Liability at the **present value of the remaining lease payments to be made over the lease term, discounted using the rate implicit in the lease (or if that rate cannot be readily determined, the lessee's incremental borrowing rate)**. Lease payments used in measuring the lease liability are amounts due to the lessor excluding any payments that a lessee makes before lease commencement.(Refer Section 3.3 Lease payments).

Illustration 27: Initial measurement of lease liability

Entity L enters into a lease for 10 years, with a single lease payment payable at the beginning of each year. The initial lease payment is ₹ 100,000. Lease payments will increase by the rate of LIBOR each year. At the date of commencement of the lease, LIBOR is 2 per cent.

Assume that the interest rate implicit in the lease is 5 per cent. How lease liability is initially measured?

Solution:

In the given case, the lease payments depend on a rate (i.e., LIBOR) and hence is included in measuring lease liability, As per Ind AS 116, the lease payments should initially be measured using the rate (i.e. LIBOR) as at the commencement date. LIBOR at that date is 2 per cent;

therefore, in measuring the lease liability, it is assumed that each year the payments will increase by 2 per cent, as follows

Year	Lease Payment	Discount factor @ 5%	PV of lease payments
1	1,00,000	1	100,000
2	1,02,000	0.952	97,102
3	1,04,040	0.907	94,364
4	1,06,121	0.864	91,689
5	1,08,243	0.823	89,084
6	1,10,408	0.784	86,560
7	1,12,616	0.746	84,012
8	1,14,869	0.711	81,672
9	1,17,166	0.677	79,321
10	1,19,509	0.645	77,083
			8,80,887

Therefore, the lease liability is initially measured at ₹ 8,80,887

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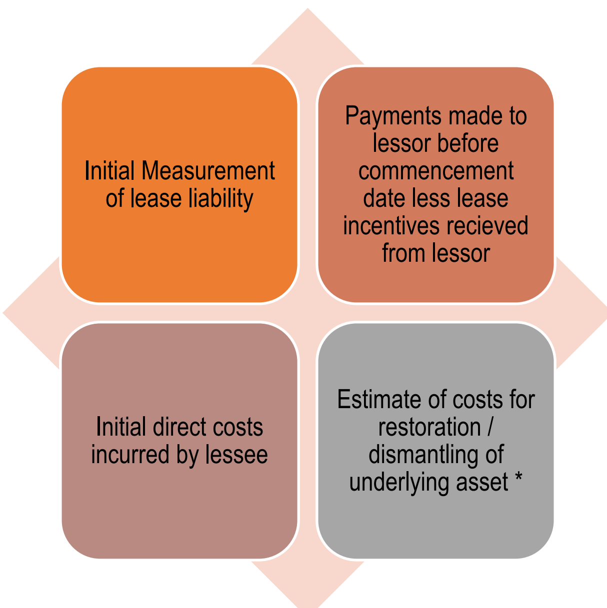
Measuring the right-of-use asset:

A lessee initially measures the ROU Asset at **COST**, which consists of ***ALL*** of the following:



* On initial measurement, a lessee is required to recognise dismantling, removal and restoration costs as part of the ROU Asset. Costs may be incurred at lease commencement or during a particular period as a consequence of having used an underlying asset. Costs that are incurred during a particular period as a consequence of having used the ROU Asset to produce inventories are accounted for under Ind AS 2 *Inventories*. The liability associated with dismantling, removal and restoration costs is recognised and measured in accordance with Ind AS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Illustration 28: Measuring right-of-use asset

Entity Y and Entity Z execute a 12-year lease of a railcar with the following terms on January 1, 2016:

- *The lease commencement date is February 1, 2016.*
- *Entity Y must pay Entity Z the first monthly rental payment of ₹ 10,000 upon execution of the lease.*
- *Entity Z will pay Entity Y ₹ 50,000 cash incentive to enter into the lease payable upon lease execution.*

Entity Y incurred ₹ 1,000 of initial direct costs, which are payable on February 1, 2016. Entity Y calculated the initial lease liability as the present value of the lease payments discounted using its incremental borrowing rate because the rate implicit in the lease could not be readily determined; the initial lease liability is ₹ 850,000.

How would Lessee Company measure and record this lease?

Solution:

Entity Y would calculate the right-of-use asset as follows: ₹

Initial measurement of lease liability	**8,50,000**
Lease payments made to Entity Z at or before the commencement date	10,000
Lease incentives received from Entity Z	(50,000)
Initial direct cost	1,000
Initial measurement of right-of-use asset	**8,11,000**

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Illustration 29 - Dismantling costs to be included in initial measurement of ROU Asset

Company H leases an aircraft for a period of 5 years. The aircraft must undergo a planned check after every 100,000 flight hours. At the end of the lease, company H must have a check performed (or refund the costs to the lessor), irrespective of the actual number of flight hours. What are the lease payments for purposes of calculating ROU asset?

Solution:

In the given case, the legal requirement to perform a check after every 1,00,000 flight hours does not directly lead to an obligation as it depends on future circumstances. However, as the check must be carried out at the end of the lease irrespective of the actual number of flight hours gives rise to an obligation.

As a result, company H has to recognize a provision for the costs of the final check ("present value of the expected cost") at the beginning of the lease term. At the same time, these costs must be included in the cost of the right-of-use (ROU) asset pursuant to para 24 (d) of Ind AS 116.

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3.4.2 Subsequent Measurement

3.4.2.1 Right-of-use assets (ROU Asset)

After the commencement date, the right-of-use asset should be measured using a cost model, unless it applies the revaluation model as specified under Ind AS 16.

Cost model for right-of-use assets:

To follow the cost model, an entity measures a right-of-use asset at cost:

(a) Less **accumulated depreciation** and accumulated impairment losses (recognised in accordance with Ind AS 36, Impairment of Assets); and

(b) Adjusted for **re-measurements of the lease liability** specified in section 3.4.3

Depreciation for right-of-use assets

ROU Assets measured under the cost model should be depreciated in accordance with the depreciation requirements given in Ind AS 16, subject to the following:

- If the lease transfers ownership of the underlying asset to the lessee by the end of the lease term, or if the cost of the ROU Asset reflects that the lessee will exercise a purchase option, the ROU Asset should be depreciated from the commencement date to the end of the useful life of the underlying asset;
- otherwise, the right-of-use asset should be depreciated from the commencement date to the earlier of the end of the useful life of the ROU Asset and the end of the lease term.

Where, **'useful life'** is defined as the period over which an asset is expected to be available for use by an entity; or the number of production or similar units expected to be obtained from an asset by an entity.

Therefore, if the ownership of the underlying asset transfers to the lessee at the end of the lease term, or it is reasonably certain that the lessee will exercise a purchase option, depreciation is based on the useful life of the underlying asset. Otherwise, depreciation is determined by reference to the useful life of the right-of-use asset (provided that is not longer than the lease term).

3.4.2.2 Lease liability:

A Lease Liability should be accounted for in a manner similar to other financial liabilities (i.e., on an amortised cost basis). Consequently, the lease liability is accreted using an amount that produces a constant periodic discount rate on the remaining balance of the liability (i.e., the discount rate determined at commencement, as long as a reassessment requiring a change in the discount rate has not been triggered). Lease payments reduce the lease liability when paid.

Thus, after the commencement date, a lessee shall measure the lease liability by:

a. increasing the carrying amount to reflect interest on the lease liability;

b. reducing the carrying amount to reflect the lease payments made; and

c. remeasuring the carrying amount to reflect any reassessment or lease modifications or to reflect revised in-substance fixed lease payments.

3.4.2.3 Expense recognition

Lessees recognise the following items in expense for leases:

- Depreciation of the ROU Asset
- Interest expense on the Lease Liability
- Variable lease payments that are <u>not included</u> in the lease liability (***for e.g.***, variable lease payments that do not depend on an index or rate)
- Impairment of the ROU Asset

These expenses are further explained below:

Depreciation of the ROU Asset and Interest on the Lease Liability	***Variable lease payments***	***Impairment of the ROU Asset***
After the commencement date, a lessee recognises depreciation of the ROU Asset and separately recognises interest on the lease liability. When a lessee depreciates the ROU Asset on a straight-line basis, the total periodic expense (i.e., the sum of interest and depreciation expense) is generally higher in the early periods and lower in the later periods. Interest	After the commencement date, lessees recognise in profit or loss, any variable lease payments **<u>not included</u>** in the measurement of the lease liability in the period in which the event or condition that triggers those payments occur.	Lessees' ROU Assets are subject to existing impairment requirements in Ind AS 36, *Impairment of Assets*. If a lessee determines that a ROU Asset is impaired, it recognises an **<u>impairment loss</u>** and measures the ROU Asset at its carrying amount immediately after the impairment. A lessee subsequently depreciates, generally on a straight-line basis, the ROU Asset from the date of the impairment to the earlier of the end of the useful

expense decreases as cash payments are made during the lease term and the lease liability decreases because a constant interest rate is applied to the lease liability. Therefore, more interest expense is incurred in the early periods and less in the later periods. This trend in the interest expense, combined with straight-line depreciation of the ROU Asset, results in a **front-loaded expense recognition pattern**.		life of the ROU Asset or the end of the lease term. However, the depreciation period is the remaining useful life of the underlying asset if the lessee is reasonably certain to exercise an option to purchase the underlying asset or if the lease transfers ownership of the underlying asset to the lessee by the end of the lease term.

Let us have a look at illustration on 'Lessee Accounting':

Illustration 30 - Lessee Accounting

Entity ABC (lessee) enters into a three-year lease of equipment. Entity ABC agrees to make the following annual payments at the ***end*** *of each year:*

₹ 20,000 in year one

₹ 30,000 in year two

₹ 50,000 in year three.

For simplicity purposes, there are no other elements to the lease payments (like purchase options, lease incentives from the lessor or initial direct costs). Assumed a discount rate of 12% (which is Entity ABC's incremental borrowing rate because the interest rate implicit in the lease cannot be readily determined). Entity ABC depreciates the ROU Asset on a straight-line basis over the lease term.

How would Entity ABC would account for the said lease under Ind AS 116?

Solution:

At the commencement date, Entity ABC would initially recognise ROU Asset and the corresponding Lease Liability of ₹ **77,364** which is calculated as follows:

Year	*Payments (Cash flows)*	*Discounting Factor @12%*	*Discounted Cash flows / Present Value*
1	20,000	0.8929	17,858
2	30,000	0.7972	23,916

3	50,000	0.7118	35,590
	1,00,000		**77,364**

Then, the next step would be to prepare a schedule for Lease Liability and ROU Asset as follows:

Lease Liability

Year	*Opening balance*	*Interest Expense*	*Payments*	*Closing balance*
1	77,364	9,284	(20,000)	66,648
2	66,648	7,998	(30,000)	44,646
3	44,646	5,354*	(50,000)	-

* Difference of ₹ 4 is due to approximation.

ROU Asset (assuming no lease incentives, no initial direct costs, etc.):

Year	*Opening balance*	*Depreciation*	*Closing balance*
1	77,364	(25,788)	51,576
2	51,576	(25,788)	25,788
3	25,788	(25,788)	-

At lease commencement, Entity ABC would recognise the Lease Liability and the corresponding ROU Asset as follows:

ROU Asset Dr.	77,364	
To Lease Liability		77,364
To initially recognise the Lease Liability and the corresponding ROU Asset		

The following journal entries would be recorded in the first year:

Interest Expense Dr.	9,284	
To Lease Liability		9,284
To record interest expense and accrete the lease liability using the effective interest method (₹ 77,364 x 12%)		

Depreciation Expense Dr.	25,788	
To ROU Asset		25,788
To record interest expense and accrete the lease liability using the straight line method (₹ 77,364 / 3 years)		

Lease Liability Dr.	20,000	
To Cash / Bank		20,000
To record lease payment		

Following is the summary of the said lease contract's accounting (assuming no changes due to reassessment):

Particulars	***Initially***	***Year 1***	***Year 2***	***Year 3***
Cash lease payments		20,000	30,000	50,000
Lease Expense Recognised:				
Interest Expense		9,284	7,998	5,354
Depreciation Expense		25,788	25,788	25,788
Total Periodic Expense		35,072	33,786	31,142
Balance Sheet:				
ROU Asset	77,364	51,576	25,788	-
Lease Liability	(77,364)	(66,648)	(44,646)	-

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Illustration 31 - Subsequent measurement using cost model

Company EFG enters into a property lease with Entity H. The initial term of the lease is 10 years with a 5- year renewal option. The economic life of the property is 40 years and the fair value of the leased property is ₹ 50 Lacs. Company EFG has an option to purchase the property at the end of the lease term for ₹ 30 lacs. The first annual payment is ₹ 5 lacs with an increase of 3% every year thereafter. The implicit rate of interest is 9.04%. Entity H gives Company EFG an incentive of ₹ 2 lacs (payable at the beginning of year 2), which is to be used for normal tenant improvement.

Company EFG is reasonably certain to exercise that purchase option. How would EFG measure the right-of-use asset and lease liability over the lease term?

Solution:

As per Ind AS 116, Company EFG would first calculate the lease liability as the present value of the annual lease payments, less the lease incentive paid in year 2, plus the exercise price of the purchase option using the rate implicit in the lease of approximately 9.04%.

PV of lease payments, less lease incentive (W.N. 1)	₹ 37,39,648
PV of purchase option at end of lease term (W.N. 2)	₹ 12,60,000
Total lease liability	**₹ 49,99,648 or ₹ 50,00,000 (approx.)**

The right-of-use asset is equal to the lease liability because there is no adjustment required for initial direct costs incurred by Company EFG, lease payments made at or before the lease commencement date, or lease incentives received prior to the lease commencement date.

Entity EFG would record the following journal entry on the lease commencement date.

Right-of-use Asset Dr.	₹ 50,00,000	
To Lease Liability		₹ 50,00,000
To record ROU asset and lease liability at the commencement date.		

Since the purchase option is reasonably certain to be exercised, EFG would amortize the right-of-use asset over the economic life of the underlying asset (40 years). Annual amortization expense would be ₹ 1,25,000 (₹ 50,00,000 / 40 years)

Interest expense on the lease liability would be calculated as shown in the following table. This table includes all expected cash flows during the lease term, including the lease incentive paid by Entity H and Company EFG's purchase option.

Year	Payment	Principal paid at the beginning of the year	Interest paid	Interest expense	Lease Liability (end of the year
	a	b= a-c	c = (d of pvs. Year)	d = [(e of pvs. year- a) x 9.04%]	e = (e of pvs. Year + d – a)
Commencement					50,00,000
Year 1	5,00,000	5,00,000	-	4,06,800	49,06,800
Year 2	3,15,000*	(91,800)	4,06,800	4,15,099	50,06,899
Year 3	5,30,450	1,15,351	4,15,099	4,04,671	48,81,120
Year 4	5,46,364	1,41,693	4,04,671	3,91,862	47,26,618
Year 5	5,62,754	1,70,892	3,91,862	3,76,413	45,40,277
Year 6	5,79,637	2,03,224	3,76,413	3,58,042	43,18,682
Year 7	5,97,026	2,38,984	3,58,042	3,36,438	40,58,094
Year 8	6,14,937	2,78,499	3,36,438	3,11,261	37,54,418
Year 9	6,33,385	3,22,124	3,11,261	2,82,141	34,03,174
Year 10	6,52,387	3,70,246	2,82,141	2,49,213*	30,00,000
Year 10	30,00,000	27,50,787	2,49,213*	-	-
Total	**85,31,940**	**50,00,000**	**35,31,940**	**35,31,940**	

*(5,00,000 + increased by 3% - lease incentive paid amounting to 2,00,000)

Although the lease was for 10 years, the asset had an economic life of 40 years. When Company EFG exercises its purchase option at the end of the 10-year lease, it would have fully extinguished its lease liability but continue depreciating the asset over the remaining useful life.

Working Notes

1. Calculating PV of lease payments, less lease incentive:

Year	Lease Payment (A)	Present value factor @ 9.04% (B)	Present value of lease payments (A*B=C)
Year 1	5,00,000	1	5,00,000
Year 2	3,15,000	0.92	2,89,800
Year 3	5,30,450	0.84	4,45,578
Year 4	5,46,364	0.77	4,20,700
Year 5	5,62,754	0.71	3,99,555
Year 6	5,79,637	0.65	3,76,764
Year 7	5,97,026	0.59	3,52,245
Year 8	6,14,937	0.55	3,38,215
Year 9	6,33,385	0.50	3,16,693
Year 10	6,52,387	0.46	3,00,098
Total			**37,39,648**

2. Calculating PV of purchase option at end of lease term:

Year	Payment on purchase option (A)	Present value factor @ 9.04% (B)	Present value of purchase option (A*B=C)
Year 10	30,00,000	0.42	12,60,000
Total			**12,60,000**

The discount rate for year 10 is different in the above calculations because in the earlier one its beginning of year 10 and in the later one its end of the year 10.

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3.4.2.4 Impairment of ROU Assets

Lessees' ROU Assets are subject to existing impairment requirements in Ind AS 36 *Impairment of Assets*. Ind AS 36 requires an impairment indicator analysis at each reporting period. If any indicators are present, the entity is required to estimate the recoverable amount of the asset (or the cash-generating unit (CGU) of which the asset is a part). The entity has to recognise an impairment loss if the recoverable amount of the CGU is less than the carrying amount of the CGU. After an impairment loss is recognised, the adjusted carrying amount of the ROU Asset would be its new basis for depreciation.

Subsequent reversal of a previously recognised impairment loss needs to be assessed if there is any indication that an impairment loss recognised in prior periods may no longer exist or may have decreased. In recognising any reversal, the increased carrying amount of the asset must not exceed the carrying amount that would have been determined after depreciation, had there been no impairment.

3.4.2.5 Leases denominated in a foreign currency

Lessees apply Ind AS 21 *The Effects of Changes in Foreign Exchange Rates*, to leases denominated in a foreign currency. Lessees remeasure the foreign currency-denominated lease liability using the exchange rate at each reporting date, like they do for other monetary liabilities. Any changes to the lease liability due to exchange rate changes are recognised in profit or loss. Because the ROU Asset is a non-monetary asset measured at historical cost, it is not affected by changes in the exchange rate.

This approach could result in volatility in profit or loss from the recognition of foreign currency exchange gains or losses, but it will be clear to the users of financial statements that the gains or losses result solely from changes in exchange rates.

3.4.3 Remeasurement

Ind AS 116 requires lessees to **REMEASURE LEASE LIABILITIES** upon a change in lease payments on account of **ANY** of the following:

- The reassessment of lease term on account of reasonable certainty to exercise/not exercise of extension and/or termination option
- The reassessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset
- In-substance fixed lease payments
- The amounts expected to be payable under residual value guarantees
- Future lease payments resulting from a change in an index or rate

When to use the 'original' and a 'revised' discount rate?

Revised Discount Rate	*Original Discount Rate*
Lessees use a **revised** discount rate when lease payments are updated for - reassessment of the lease term ***OR***	Lessees use the **original** discount rate when lease payments are updated for - a change in expected amounts for

- a reassessment of a purchase option. The revised discount rate is based on the interest rate implicit in the lease for the **<u>REMAINDER</u>** of the lease term. If that rate cannot be readily determined, the lessee uses its incremental borrowing rate.	residual value guarantees ***AND*** - payments dependent on an index or rate, **<u>unless</u>** the rate is a floating interest rate. - the variability of payments is resolved so that they become in-substance fixed payments.

When a lease includes a **<u>market rate adjustment</u>** (a market rent review), the negotiations between the lessee and the lessor may take some time to complete (i.e., the negotiation period). ***For e.g.***, consider a 10-year lease that has a market rate adjustment that applies from the end of year 5. The market rent review negotiations begin during year 5, but are not completed until later in year 6. During year 6, while the negotiation is ongoing, the lessee is required to pay the original contractual lease payments. At the conclusion of the negotiation period (i.e., upon a final determination of the lease payments for year 6 until year 10), the new lease payments apply retrospectively from the beginning of year 6. In this example, the lessee does not adjust the lease payments at the beginning of year 6 for the expected increase in rent. Rather, any adjustment is recognised as an adjustment to lease payments when the market rent review is finalised and the change in contractual cash flows takes effect.

A lessee recognises the amount of the remeasurement of the lease liability as an adjustment to the ROU Asset. However, if the carrying amount of the ROU Asset is reduced to zero and there is a further reduction in the measurement of the lease liability, a lessee recognises any remaining amount of the remeasurement in profit or loss.

Illustration 32- Remeasurement of a lease with variable lease payments

Entity W entered into a contract for lease of retail store with Entity J on January 01/01/2017. The initial term of the lease is 5 years with a renewal option of further 3 years. The annual payments for initial term and renewal term is ₹ 100,000 and ₹ 110,000 respectively. The annual lease payment will increase based on the annual increase in the CPI at the end of the preceding year. For example, the payment due on 01/01/18 will be based on the CPI available at 31/12/17.

Entity W's incremental borrowing rate at the lease inception date and as at 01/01/2020 is 5% and 6% respectively and the CPI at lease commencement date and as at 01/01/2020 is 120 and 125 respectively.

At the lease commencement date, Entity W did not have a significant economic incentive to exercise the renewal option. In the first quarter of 2020, Entity W installed unique lease improvements into the retail store with an estimated five-year economic life. Entity W determined that it would only recover the cost of the improvements if it exercises the renewal option, creating a significant economic incentive to extend.

Is Entity W required to remeasure the lease in the first quarter of 2020?

Solution:

Since Entity W is now reasonably certain that it will exercise its renewal option, it is required to remeasure the lease in the first quarter of 2020.

The following table summarizes information pertinent to the lease remeasurement.

Remeasured lease term	**5 years; 2 years remaining in the initial term plus 3 years in the renewal period**
Entity W's incremental borrowing rate On the remeasurement date	6%
CPI available on the remeasurement date	125
Right-of-use asset immediately before the remeasurement	₹ 1,81,840 (Refer note 1)
Lease liability immediately before the remeasurement	₹ 1,85,947 (Refer note 1)

To remeasure the lease liability, Entity W would first calculate the present value of the future lease payments for the new lease term (using the updated discount rate of 6%). The following table shows the present value of the future lease payments based on an updated CPI of 125. Since the initial lease payments were based on a CPI of 120, the CPI has increased by 4% approx. As a result, Entity W would increase the future lease payments by 4%. As shown in the table, the revised lease liability is ₹ 490,589.

Year	**4**	**5**	**6**	**7**	**8**	**Total**
Lease payment	104,000	104,000	114,400	114,400	114,400	551,200
Discount	1	0.943	0.890	0.840	0.792	
Present value	104,000	98,072	101,816	96,096	90,605	490,589

To calculate the adjustment to the lease liability, Entity W would compare the recalculated and original lease liability balances on the remeasurement date.

Revised lease liability	490,589
Original lease liability	(1,85,947)
	3,04,642

Entity W would record the following journal entry to adjust the lease liability.

ROU Asset Dr.	3,04,642	
To Lease liability		3,04,642
Being lease liability and ROU asset adjusted on account of remeasurement.		

Working Notes:

1 Calculation of ROU asset before the date of remeasurement

Year beginning	Lease Payment (A)	Present value factor @ 5% (B)	Present value of lease payments (AxB=C)
1	1,00,000	1.000	1,00,000
2	1,00,000	0.952	95,200
3	1,00,000	0.907	90,700
4	1,00,000	0.864	86,400
5	1,00,000	0.823	82,300
Lease liability as at commencement date			**4,54,600**

2 Calculation of Lease Liability and ROU asset at each year end

Year	Lease Liability				ROU asset		
	Initial value	Lease payments	Interest expense	Closing balance	Initial Value	Depreciation	Closing balance
1	4,54,600	1,00,000	-	3,54,600	4,54,600	90,920	3,63,680
2	3,54,600	1,00,000	17,730	2,72,330	3,63,680	90,920	2,72,760
3	2,72,330	1,00,000	13,617	1,85,947	2,72,760	90,920	1,81,840
4	1,85,947				1,81,840		

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3.4.4 Lease Modifications

A 'lease modification' is a **change** in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (***for e.g.***, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term).

The following are examples of lease modifications that may be negotiated after the lease commencement date:

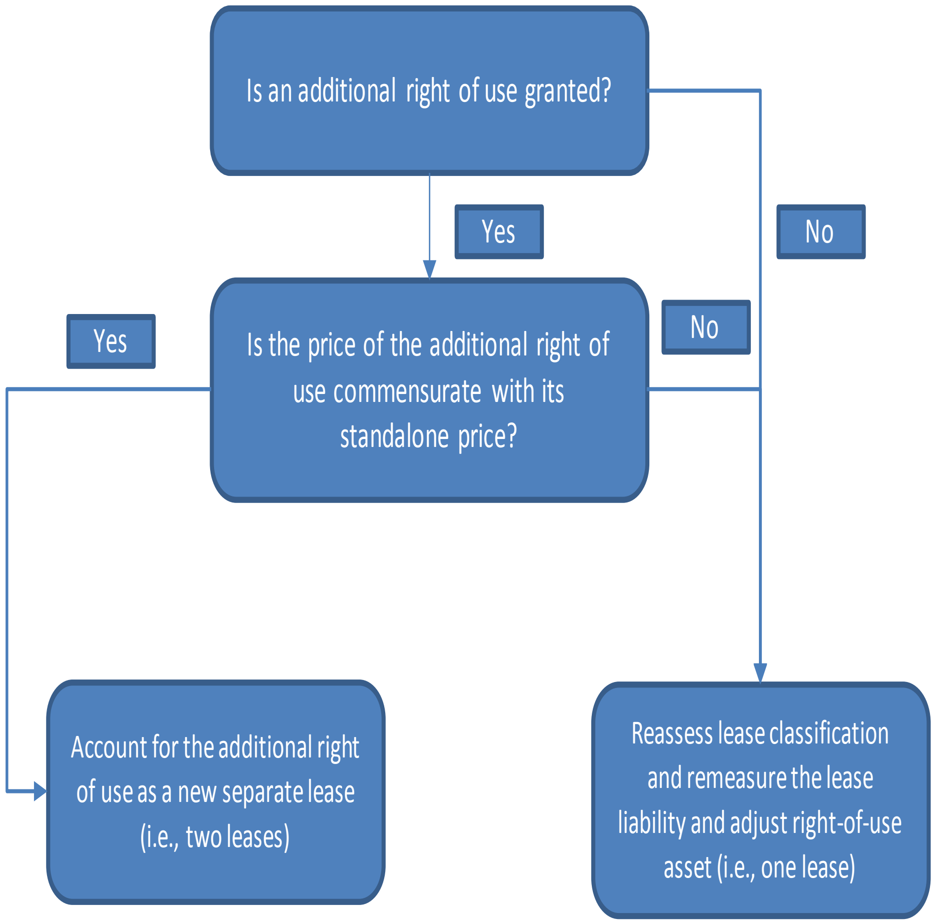
- A lease extension
- Early termination of the lease
- A change in the timing of lease payments
- Leasing additional space in the same building
- Surrendering a part of the underlying asset.

If a lease is modified (as stated above), the modified contract is evaluated to determine whether it is or contains a lease. If a lease continues to exist, lease modification can result in:

- A separate lease OR
- A change in the accounting for the existing lease (i.e., not a separate lease).

The exercise of an existing purchase or renewal option or a change in the assessment of whether such options are reasonably certain to be exercised are **not lease modifications but can result in the remeasurement** of Lease Liabilities and ROU Assets (Remeasurement – as discussed above).

The following diagram demonstrates Lessee's analysis of a change in a lease:



Let us understand in detail when and how the lease modification will be accounted as a separate lease contract and not as a separate lease contract:

Modification – Separate lease

A lease modification is accounted for as a separate lease if both:

a. The modification increases the scope of the lease by adding the right to use one or more underlying assets; **and**

b. The consideration for the lease increases by an amount commensurate with the standalone price for the increase in scope.

If both criteria are met, a lessee would follow the previous guidance on the initial recognition and measurement of lease liabilities and right-of-use assets.

Illustration 33 - Modification that is a separate lease

Lessee enters into a 10-year lease for 2,000 square metres of office space. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to include an additional 3,000 square metres of office space in the same building. The additional space is made available for use by Lessee at the end of the second quarter of Year 6. The increase in total consideration for the lease is commensurate with the current market rate for the new 3,000 square metres of office space, adjusted for the discount that Lessee receives reflecting that Lessor does not incur costs that it would otherwise have incurred if leasing the same space to a new tenant (for example, marketing costs).

How should the said modification be accounted for?

Solution:

Lessee accounts for the modification as a separate lease, separate from the original 10-year lease because the modification grants Lessee an additional right to use an underlying asset, and the increase in consideration for the lease is commensurate with the stand-alone price of the additional right-of-use adjusted to reflect the circumstances of the contract. In this example, the additional underlying asset is the new 3,000 square metres of office space. Accordingly, at the commencement date of the new lease (at the end of the second quarter of Year 6), Lessee recognises a ROU Asset and a lease liability relating to the lease of the additional 3,000 square metres of office space. Lessee does not make any adjustments to the accounting for the original lease of 2,000 square metres of office space as a result of this modification.

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Modification- Not Separate Lease:

If a lease modification fails the test above (e.g. additional right of use granted, but not at a standalone price) or the modification is of any other type (e.g. a decrease in scope from the original contract), the lessee must modify the initially recognised components of the lease contract.

The accounting treatment required for lease modifications that are not accounted for as separate leases is summarised below:

Decrease in scope

- Remeasure lease liability using revised discount rate * (1)
- Decrease right-of-use asset by its relative scope compared to the original lease (2)
- Difference between (1) and (2) recognised in P&L

All other lease modification

- Remeasure lease liability using revised discount rate*
- Remeasure right-of-use asset by same amount

* The implicit rate in the lease is to be used. If it cannot be readily determined, the incremental rate of borrowing is to be used.

The re-measurements above occur as of the effective date of the lease modification on a prospective basis.

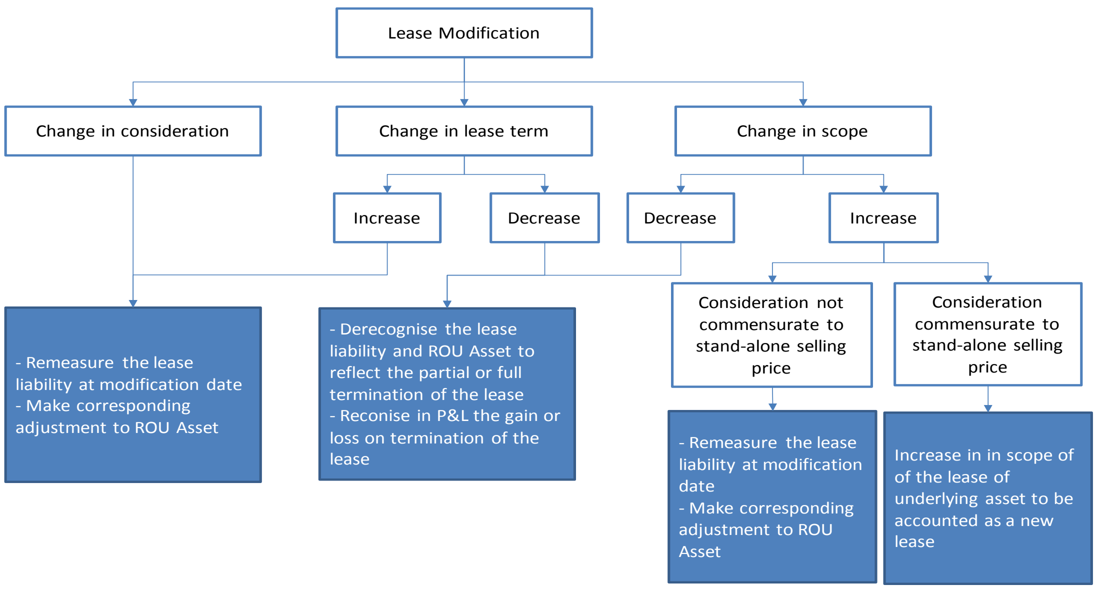
In some cases, the lessee and lessor may agree to a modification to the lease contract that starts at a later date (i.e., the terms of the modification take effect at a date later than the date when both parties agreed to the modification). This can be understood with the help of a following example:

A lessee enters into a lease arrangement with a lessor to lease an asset for 10 years. At the beginning of year 8, the lessee and lessor agree to a modification to the contract that will take effect from the beginning of year 9.

Scenario 1 ***(Increase in scope – Not a Separate Lease)***	***Scenario 2*** ***(Increase in scope – Separate Lease)***	***Scenario 3*** ***(Decrease in scope)***
If the modification is an increase in the scope that does not result in a separate lease, the lessee will re-allocate the consideration in the	If the modification results in a separate lease component, the lessee will allocate the consideration in the modified contract to each of the existing and new lease and non-lease	If the modification is a decrease in the scope, the lessee will re-allocate the consideration in the modified contract to each existing lease and non-lease component and

modified contract to each of the existing lease and non-lease components and remeasure the lease liability at the date both parties agreed to the modification (the beginning of year 8).	components at the date both parties agreed to the modification (the beginning of year 8). The lessee will remeasure the lease liability for the existing lease components at that date as well. However, recognition of the lease liability and ROU Asset for any new lease component occurs at the commencement date of the new lease component (the beginning of year 9).	remeasure the lease liability and ROU Asset at the effective date of the modification (the beginning of year 8).

This can be summarised with the help of the following flow chart:



Following are some more examples for 'lease modification':

Illustration 34 - Modification that increases the scope of the lease by extending the contractual lease term

Lessee enters into a 10-year lease for 5,000 square metres of office space. The annual lease payments are ₹ 1,00,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a. At the beginning of Year 7, Lessee and Lessor agree to amend the original lease by *extending the contractual lease term by four years. The annual lease payments are unchanged (i.e., ₹ 1,00,000 payable at the end of each year from Year 7 to Year 14). Lessee's incremental borrowing rate at the beginning of Year 7 is 7% p.a.*

How should the said modification be accounted for?

Solution:

At the effective date of the modification (at the beginning of Year 7), Lessee remeasures the lease liability based on:

(a) An eight-year remaining lease term

(b) Annual payments of ₹ 1,00,000 and

(c) Lessee's incremental borrowing rate of 7% p.a.

The modified lease liability equals ₹ 5,97,100 (W.N.1). The lease liability immediately before the modification (including the recognition of the interest expense until the end of Year 6) is ₹ 3,46,355 (W.N.3). Lessee recognises the difference between the carrying amount of the modified lease liability and the carrying amount of the lease liability immediately before the modification (i.e., ₹ 2,50,745) (W.N. 4) as an adjustment to the ROU Asset.

Working Notes:

1. Calculation of modified lease liability:

Year	Lease Payment (A)	Present value factor @ 7% (B)	Present value of lease payments (A*B=C)
7	100,000	0.935	93,500
8	100,000	0.873	87,300
9	100,000	0.816	81,600
10	100,000	0.763	76,300
11	100,000	0.713	71,300
12	100,000	0.666	66,600
13	100,000	0.623	62,300
14	100,000	0.582	58,200
Modified lease liability			**5,97,100**

2. Calculation of Lease liability as at commencement date:

Year	Lease Payment (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	100,000	0.943	94,300
2	100,000	0.890	89,000
3	100,000	0.840	84,000

4	100,000	0.792	79,200
5	100,000	0.747	74,700
6	100,000	0.705	70,500
7	100,000	0.665	66,500
8	100,000	0.627	62,700
9	100,000	0.592	59,200
10	100,000	0.558	55,800
Lease liability as at modification date			**7,35,900**

3. **Calculation of Lease liability immediately before modification date:**

Year	Opening lease liability (A)	Interest @ 6% (B) = [A x 6%]	Lease payments (C)	Closing liability (D) = [A+B-C]
1	7,35,900	44,154	100,000	6,80,054
2	6,80,054	40,803	100,000	6,20,857
3	6,20,857	37,251	100,000	5,58,108
4	5,58,108	33,486	100,000	4,91,594
5	4,91,594	29,496	100,000	4,21,090
6	4,21,090	25,265	100,000	3,46,355
	Lease liability as at modification date			3,46,355

4. **Adjustment to ROU asset:**

Modified Lease liability	5,97,100
Original Lease liability as at modification date	(3,46,355)
Adjustment to ROU asset	**2,50,745**

The ROU asset will be increased by ₹ 2,50,745 on the date of modification.

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Illustration 35 - Modification that decreases the scope of the lease

Lessee enters into a 10-year lease for 5,000 square metres of office space. The annual lease payments are ₹ 50,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease to reduce the space to only 2,500 square metres of the original space starting from the end of the *first quarter of Year 6. The annual fixed lease payments (from Year 6 to Year 10) are ₹ 30,000. Lessee's incremental borrowing rate at the beginning of Year 6 is 5% p.a.*

How should the said modification be accounted for?

Solution:

In the given case, Lessee calculates the ROU asset and the lease liabilities before modification as follows:

Year	Lease Liability				ROU asset		
	Initial value	Lease payments	Interest expense @ 6%	Closing balance	Initial Value	Depreciation	Closing balance
	a	b	c = a x 6%	d = a-b + c	e	f	g
1	3,67,950*	50,000	22,077	3,40,027	3,67,950	36,795	3,31,155
2	3,40,027	50,000	20,402	3,10,429	3,31,155	36,795	2,94,360
3	3,10,429	50,000	18,626	2,79,055	2,94,360	36,795	2,57,565
4	2,79,055	50,000	16,743	2,45,798	2,57,565	36,795	2,20,770
5	2,45,798	50,000	14,748	2,10,546	2,20,770	36,795	1,83,975
6	2,10,546				1,83,975		

*(refer note 1)

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability based on:

(a) a five-year remaining lease term,

(b) annual payments of ₹ 30,000 and

(c) Lessee's incremental borrowing rate of 5% p.a.

Year	Lease Payment(A)	Present value factor @ 5% (B)	Present value of lease payments (A x B = C)
6	30,000	0.952	28,560
7	30,000	0.907	27,210
8	30,000	0.864	25,920
9	30,000	0.823	24,690
10	30,000	0.784	23,520
Total			**1,29,900**

Lessee determines the proportionate decrease in the carrying amount of the ROU Asset on the basis of the remaining ROU Asset (i.e., 2,500 square metres corresponding to 50% of the original ROU Asset).

50% of the pre-modification ROU Asset (₹ 1,83,975) is ₹ 91,987.50.

50% of the pre-modification lease liability (₹ 2,10,546) is ₹ 1,05,273.

Consequently, Lessee reduces the carrying amount of the ROU Asset by ₹ 91,987.50 and the carrying amount of the lease liability by ₹ 1,05,273. Lessee recognises the difference between the decrease in the lease liability and the decrease in the ROU Asset (₹ 1,05,273 – ₹ 91,987.50 = ₹ 13,285.50) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Lessee recognises the difference between the remaining lease liability of ₹ 1,05,273 and the modified lease liability of ₹ 1,29,900 (which equals ₹ 24,627) as an adjustment to the ROU Asset reflecting the change in the consideration paid for the lease and the revised discount rate.

Working Note:

Calculation of Initial value of ROU asset and lease liability:

Year	Lease Payment(A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	50,000	0.943	47,150
2	50,000	0.890	44,500
3	50,000	0.840	42,000
4	50,000	0.792	39,600
5	50,000	0.747	37,350
6	50,000	0.705	35,250
7	50,000	0.665	33,250
8	50,000	0.627	31,350
9	50,000	0.592	29,600
10	50,000	0.558	27,900
			3,67,950

*****

Illustration 36 - Modification that is a change in consideration only

Lessee enters into a 10-year lease for 5,000 square metres of office space. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to reduce the lease payments from ₹ 1,00,000 per year to ₹ 95,000 per year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the *commencement date is 6% p.a. Lessee's incremental borrowing rate at the beginning of Year 6 is 7% p.a. The annual lease payments are payable at the end of each year.*

How should the said modification be accounted for?

Solution:

In the given case, Lessee calculates the ROU asset and the lease liabilities before modification as follows:

Year	Opening lease liability (A)	Interest @ 6% (B) = [A x 6%]	Lease payments (C)	Closing liability (D) = [A+B-C]
1	7,35,900	44,154	100,000	6,80,054
2	6,80,054	40,803	100,000	6,20,857
3	6,20,857	37,251	100,000	5,58,108
4	5,58,108	33,486	100,000	4,91,594
5	4,91,594	29,496	100,000	4,21,090
6	4,21,090			

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability based on:

(a) a five-year remaining lease term,

(b) annual payments of ₹ 95,000, and

(c) Lessee's incremental borrowing rate of 7% p.a.

Year	Lease Payments (A)	Present value @ 7% (B)	Present value of lease payments (A x B = C)
1	95,000	0.935	88,825
2	95,000	0.873	82,935
3	95,000	0.816	77,520
4	95,000	0.763	72,485
5	95,000	0.713	67,735
			3,89,500

Lessee recognises the difference between the carrying amount of the modified liability (₹ 3,89,500) and the lease liability immediately before the modification (₹ 4,21,090) of ₹ 31,590 as an adjustment to the ROU Asset.

Working Note:

Calculation of Initial value of ROU asset and lease liability:

Year	Lease Payment (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	100,000	0.943	94,300
2	100,000	0.890	89,000
3	100,000	0.840	84,000
4	100,000	0.792	79,200
5	100,000	0.747	74,700
6	100,000	0.705	70,500
7	100,000	0.665	66,500
8	100,000	0.627	62,700
9	100,000	0.592	59,200
10	100,000	0.558	55,800
Lease liability as at modification date			**7,35,900**

*****

Illustration 37 - Modification that both increases and decreases the scope of the lease

Lessee enters into a 10-year lease for 2,000 square metres of office space. The annual lease payments are ₹1,00,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6% p.a.

At the beginning of Year 6, Lessee and Lessor agree to amend the original lease to:

(a) include an additional 1,500 square metres of space in the same building starting from the beginning of Year 6 and

(b) reduce the lease term from 10 years to eight years. The annual fixed payment for the 3,500 square metres is ₹1,50,000 payable at the end of each year (from Year 6 to Year 8). Lessee's incremental borrowing rate at the beginning of Year 6 is 7% p.a.

The consideration for the increase in scope of 1,500 square metres of space is not commensurate with the stand-alone price for that increase adjusted to reflect the circumstances of the contract. Consequently, Lessee does not account for the increase in scope that adds the right to use an additional 1,500 square metres of space as a separate lease.

How should the said modification be accounted for?

Solution:

The pre-modification ROU Asset and the pre-modification lease liability in relation to the lease are as follows:

Year	Lease liability				ROU Asset		
	Opening balance	Interest expense @ 6%	Lease payment	Closing balance	Opening balance	Depreciation charge	Closing balance
1	7,35,900*	44,154	(1,00,000)	6,80,054	7,35,900	(73,590)	6,62,310
2	6,80,054	40,803	(1,00,000)	6,20,857	6,62,310	(73,590)	5,88,720
3	6,20,857	37,251	(1,00,000)	5,58,108	5,88,720	(73,590)	5,15,130
4	5,58,108	33,486	(1,00,000)	4,91,594	5,15,130	(73,590)	4,41,540
5	4,91,594	29,496	(1,00,000)	4,21,090	4,41,540	(73,590)	3,67,950
6	4,21,090				3,67,950		

*Refer Note 4.

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability on the basis of:

(a) A three-year remaining lease term (ie. till 8th year),

(b) Annual payments of ₹ 150,000 and

(c) Lessee's incremental borrowing rate of 7% p.a.

Year	Lease Payments (A)	Present value @ 7% (B)	Present value of lease payments (A x B = C)
1	1,50,000	0.935	1,40,250
2	1,50,000	0.873	1,30,950
3	1,50,000	0.816	1,22,400
	Modified lease liability		**3,93,600**

The modified liability equals ₹ 3,93,600, of which (a) ₹ 1,31,200 relates to the increase of ₹ 50,000 in the annual lease payments from Year 6 to Year 8 and (refer note 1) (b) ₹ 2,62,400 relates to the remaining three annual lease payments of ₹ 1,00,000 from Year 6 to Year 8 with reduction of lease term (Refer Note 3)

Decrease in the lease term:

At the effective date of the modification (at the beginning of Year 6), the pre-modification ROU Asset is ₹ 3,67,950. Lessee determines the proportionate decrease in the carrying amount of the ROU Asset based on the remaining ROU Asset for the original 2,000 square metres of office space (i.e., a remaining three-year lease term rather than the original five-year lease term). The remaining ROU Asset for the original 2,000 square metres of office space is ₹ 2,20,770 [i.e., ₹ (3,67,950 / 5) x 3 years].

At the effective date of the modification (at the beginning of Year 6), the pre-modification lease liability is ₹ 4,21,090. The remaining lease liability for the original 2,000 square metres of office space is ₹ 2,67,300 (i.e., present value of three annual lease payments of ₹ 1,00,000, discounted at the original discount rate of 6% p.a.) (refer note 2).

Consequently, Lessee reduces the carrying amount of the ROU Asset by ₹ 1,47,180 (₹ 3,67,950 – ₹ 2,20,770), and the carrying amount of the lease liability by ₹ 1,53,790 (₹ 4,21,090 – ₹ 2,67,300). Lessee recognises the difference between the decrease in the lease liability and the decrease in the ROU Asset (₹ 1,53,790 – ₹ 1,47,180 = ₹ 6,610) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Lease Liability	Dr.	1,53,790	
To ROU Asset			1,47,180
To Gain			6,610

At the effective date of the modification (at the beginning of Year 6), Lessee recognises the effect of the remeasurement of the remaining lease liability reflecting the revised discount rate of 7% p.a., which is ₹ 4,900 (₹ 2,67,300 – ₹ 2,62,400*), as an adjustment to the ROU Asset.

*(Refer note 3)

Lease Liability	Dr.	4,900	
To ROU Asset			4,900

Increase in the leased space:

At the commencement date of the lease for the additional 1,500 square metres of space (at the beginning of Year 6), Lessee recognises the increase in the lease liability related to the increase in leased space of ₹ 1,31,200 (i.e., present value of three annual lease payments of ₹ 50,000, discounted at the revised interest rate of 7% p.a.) as an adjustment to the ROU Asset.

ROU Asset	Dr.	1,31,200	
To Lease Liability			1,31,200

The modified ROU Asset and the modified lease liability in relation to the modified lease are as follows:

Year	Lease liability				ROU Asset		
	Opening balance	Interest expense @ 7%	Lease payment	Closing balance	Opening balance	Depreciation charge	Closing balance
6	3,93,600	27,552	(1,50,000)	2,71,152	3,47,100**	(1,15,700)	2,31,400
7	2,71,152	18,981	(1,50,000)	1,40,133	2,31,400	(1,15,700)	1,15,700
8	1,40,133	9,867*	(1,50,000)	-	1,15,700	(1,15,700)	-

*Difference is due to approximation.

**Refer Note 5

Working Notes:

1 Calculation of lease liability on increased consideration:

Year	Lease Payments (A)	Present value @7% (B)	Present value of lease payments (A x B = C)
1	50,000	0.935	46,750
2	50,000	0.873	43,650
3	50,000	0.816	40,800
Modified lease liability			**1,31,200**

2 Calculation of remaining lease liability for the original contract of 2000 square meters at Original discount rate:

Year	Lease Payments (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	1,00,000	0.943	94,300
2	1,00,000	0.890	89,000
3	1,00,000	0.840	84,000
Remaining lease liability			**2,67,300**

3 Calculation of remaining lease liability for the original contract of 2000 square meters at revised discount rate:

Year	Lease Payments (A)	Present value factor @ 7% (B)	Present value of lease payments (A x B = C)
1	1,00,000	0.935	93,500
2	1,00,000	0.873	87,300
3	1,00,000	0.816	81,600
Remaining lease liability			**2,62,400**

4 Calculation of Initial value of ROU asset and lease liability:

Year	Lease Payment (A)	Present value factor @ 6% (B)	Present value of lease payments (A x B = C)
1	100,000	0.943	94,300
2	100,000	0.890	89,000
3	100,000	0.840	84,000
4	100,000	0.792	79,200
5	100,000	0.747	74,700
6	100,000	0.705	70,500
7	100,000	0.665	66,500

8	100,000	0.627	62,700
9	100,000	0.592	59,200
10	100,000	0.558	55,800
Lease liability as at modification date			**7,35,900**

5 Calculation of opening balance of Modified ROU Asset at the beginning of 6th year:

The remaining ROU Asset for the original 2,000 square metres of office space after decrease in term	2,20,770
Less: Adjustment for increase in interest rate from 6% to 7%	(4,870)
Add: Adjustment for increase in leased space	1,31,200
	3,47,100

*****

3.4.5 Presentation

ROU Assets and lease liabilities are subject to the same considerations as other assets and liabilities in classifying them as current and non-current in the balance sheet. The following table depicts how lease-related amounts and activities are presented in lessees' financial statements:

Balance Sheet	*Statement of profit or loss*	*Statement of cash flows*
ROU Assets: They are presented either: - Separately from other assets (e.g., owned assets) ***OR*** - Together with other assets as if they were owned, with disclosures of the balance sheet line items that include ROU Assets and their amounts ROU Assets that meet the definition of investment property are presented as investment property	**Depreciation and Interest:** Depreciation on Right of use asset and interest expense accreted on lease liabilities are presented **separately** (i.e., they **CANNOT** be combined). This is because interest expense on the lease liability is a component of **finance costs,** which paragraph 82(b) of Ind AS 1 *Presentation of Financial Statements* requires to be presented separately in the statement of profit or loss.	**Principal portion of the lease liability:** - These cash payments are presented within financing activities **Interest portion of the lease liability:** - These cash payments are presented within financing activities **Short-term leases and leases of low-value assets:** - Lease payments pertaining to them (i.e., not recognised on the balance sheet as per Ind AS 116) are presented within operating activities

Lease Liabilities: They are presented either: - Separately from other liabilities ***OR*** - Together with other liabilities with disclosure of the balance sheet line items that includes lease liabilities and their amounts		**Variable lease payments not included in the lease liability:** - These are also presented within operating activities **Non-cash activity:** Such activity is disclosed as a supplemental non-cash item (e.g., the initial recognition of the lease at commencement)

3.4.6 Disclosure

Disclosure objective:

The objective of the disclosures is for lessees to disclose information in the notes that, together with the information provided in the balance sheet, statement of profit and loss and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessee.

Ind AS 116 requires lessees to present all disclosures in:

- a single note ***OR***
- separate section in the financial statements.

Quantitative Disclosure Requirement		
Balance sheet	***Statement of Profit and Loss***	***Statement of Cash Flows***
– Additions to right-of-use assets. – Carrying value of right-of-use assets at the end of the reporting period by class. – Maturity analysis of lease liabilities separately from other liabilities based on Ind AS 107 requirements.	– Depreciation for assets by class. – Interest expense on lease liabilities. – Short-term leases expensed* – Low-value leases expensed* – Variable lease payments expensed. – Income from subleasing. – Gains or losses arising from sale and leaseback transactions.	– Total cash outflow for leases.

* These disclosures need not include leases with lease terms of one month or less.

All of the above disclosures are required to be presented in tabular format, unless another format is more appropriate. The amounts disclosed include costs that a lessee has included in the carrying amount of another asset during the reporting period.

Other disclosure requirements also include:

- Commitments for short-term leases if the current period expense is dissimilar to future commitments.
- For right-of-use assets that meet the definition of investment property, the disclosure requirements of Ind AS 40, *Investment property*, with a few exclusions.
- For right-of-use assets where the revaluation model has been applied, the disclosure requirements of Ind AS 16, *Property, plant and equipment.*
- Entities applying the short-term and/or low-value lease exemptions are required to disclose that fact.

Qualitative Disclosure Requirements
– A summary of the nature of the entity's leasing activities;
– Potential cash outflows the entity is exposed to that are not included in the measured lease liability, including:
– Variable lease payments;
– Extension options and termination options;
– Residual value guarantees; and
– Leases not yet commenced to which the lessee is committed.
– Restrictions or covenants imposed by leases; and
– Sale and leaseback transaction information.

In providing additional information, lessees are required to consider:

(a) Whether that information is relevant to the users of the financial statements. The additional information (as specified above) is included **ONLY IF** that information is **expected to be relevant** to users of financial statements. For e.g., this is likely to be relevant if it helps those users to understand:

The flexibility provided by leases	***for e.g., a lessee can reduce its exposure by exercising termination options or renewing leases with favourable terms and conditions***
Restrictions imposed by leases	*for e.g., by requiring the lessee to maintain particular financial ratios*
Sensitivity of reported information to key variables	*for e.g., future variable lease payments*
Deviations from industry practice	*for e.g., unusual or unique lease terms and conditions that affect a lessee's lease portfolio*
Exposure to other risks arising from leases	

(b) Whether that information is apparent from information either presented in the primary financial statements or disclosed in the notes. A lessee need not duplicate information that is already presented elsewhere in the financial statements.

3.5 LESSOR ACCOUNTING

3.5.1 Lease Classification

A **'lessor'** is defined as an entity that provides the right to use an **underlying asset** for a period of time in exchange for consideration.

At inception, lessors classify all leases as FINANCE LEASE or OPERATING LEASE. Lease classification is very important because it determines how and when a lessor recognises lease income and what assets are recorded. Classification is based on the extent to which the risks and rewards incidental to ownership of the underlying asset lie with the lessor or the lessee. It depends on the substance of the transaction rather than the form of the contract.

Where, a **'Finance Lease'** is defined as a **lease** that transfers substantially all the risks and rewards incidental to ownership of an **underlying asset**.

Where, an **'Operating Lease'** is defined as a **lease** that does not transfer substantially all the risks and rewards incidental to ownership of an **underlying asset**.

Ind AS 116 lists a number of examples that individually, or in combination, would normally lead to a lease being classified as a **FINANCE LEASE**:

Ownership	• The lease transfers ownership of the asset to the lessee by the end of the lease term
Purchase option	• The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception date, that the option will be exercised
Lease term	• The lease term is for the major part of the economic life of the asset even if title is not transferred
PV of Minimum Lease Payments	• At the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the asset *
Specialised Nature	• The asset is of such a specialised nature that only the lessee can use it without major modifications

*The term "substantially all" is not defined in Ind AS 116.

Additionally, Ind AS 116 lists the following indicators of situations that, <u>individually or in combination</u>, could also lead to a lease being classified as a **<u>FINANCE LEASE</u>**:

Loss on cancellation	• If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee
Risk of fair value of the residual asset	• Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (e.g., in the form of a rent rebate that is equal to most of the sale proceeds at the end of the lease)
Option to extend lease	• The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent

Other considerations that could be made in determining the economic substance of the lease arrangement include the following:

- Are the lease rentals based on a market rate for use of the asset (which would indicate an operating lease) or a financing rate for use of the funds, which would be indicative of a finance lease?
- Is the existence of put and call options a feature of the lease? If so, are they exercisable at a predetermined price or formula (indicating a finance lease) or are they exercisable at the market price at the time the option is exercised (indicating an operating lease)?

Lease classification test for land and buildings:

For a lease that includes both land and buildings elements, the lessor **separately assesses** the classification of each element as a finance lease or an operating lease, **having fact that land normally has an indefinite economic life**.

The lessor allocates lease payments between the land and the buildings elements in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease at the inception date. If the lease payments cannot be allocated reliably between these two elements, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case, the entire lease is classified as an operating lease.

For a lease of land and buildings in which the amount for the land element is **immaterial** to the lease, the lessor may treat the land and buildings as a **single unit** for the purpose of lease classification and classify it as a finance lease or an operating lease. In such a case, the lessor regards the economic life of the buildings as the economic life of the **entire** underlying asset.

Residual value guarantees included in the lease classification test:

In evaluating Ind AS 116's lease classification criteria, lessors are required to include in the 'substantially all' test, **any (i.e., the maximum obligation) residual value guarantees** provided by both lessees and any other third party unrelated to the lessor.

Reassessment of lease classification:

Lessors are required to **reassess** the lease classification only if there is a lease modification (i.e., a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease). Lessors reassess lease classification as at the **effective date of the modification** using the modified conditions at that date. If a lease modification results in a separate new lease, that new lease would be classified in the **same manner** as any new lease.

Key concepts applied by the lessor:

'Gross investment in the lease' is the **SUM** of:

(a) the lease payments receivable by a lessor under a finance lease; ***AND***

(b) any unguaranteed residual value accruing to the lessor.

'**Net investment in the lease'** is the gross investment in the lease discounted at the interest rate implicit in the lease.

'**Unguaranteed residual value'** is that portion of the residual value of the underlying asset, the realisation of which by a lessor is not assured or is guaranteed solely by a party related to the lessor.

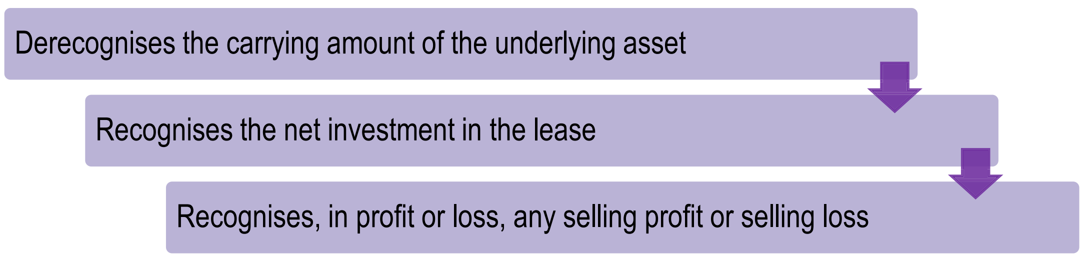
3.5.2 Finance Leases

3.5.2.1 Recognition

At the commencement date, a lessor shall recognise assets held under a finance lease in its balance sheet and present them as a receivable at an amount equal to the **net investment in the lease**.

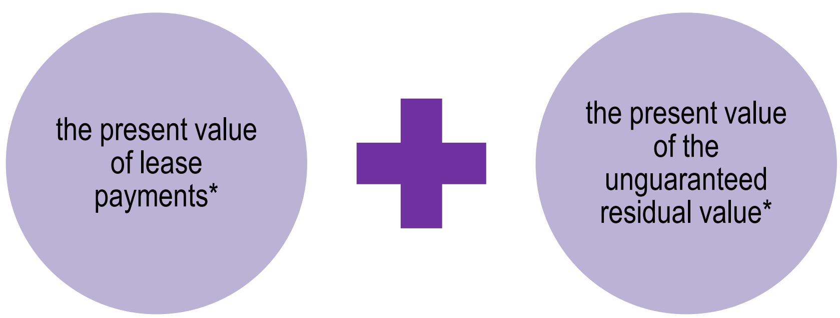
3.5.2.2 Initial Measurement

At lease commencement, a lessor accounts for a finance lease, as follows:



For finance leases (other than those involving manufacturer and dealer lessors), initial direct costs are included in the initial measurement of the finance lease receivable. Initial direct costs are included in the lease, and are not added separately to the net investment in lease.

The net investment in the lease is initially measured as the sum of:



*discounted using the interest rate implicit in the lease (i.e., the discount rate).

*Lease payments as described in section 3.3.3

Any selling profit or loss is measured as the difference between the fair value of the underlying asset or the lease receivable, if lower, and the carrying amount of the underlying asset, net of any unguaranteed residual asset.

3.5.2.3 Initial Measurement – Manufacturer or Dealer Lessors

At the commencement date, a manufacturer or dealer lessor recognises selling profit or loss in accordance with its policy for outright sales to which Ind AS 115 applies.

Therefore, at lease commencement, a manufacturer or dealer lessor recognises the following:

The fair value of the underlying asset as revenue ***OR*** the present value of the lease payments discounted using a market rate of interest, whichever is **lower**.

The cost (or carrying amount) of the asset (less) the present value of the unguaranteed residual value, as cost of sale.

The selling profit or loss in accordance with the policy for outright sales.

At the commencement date, a manufacturer or dealer lessor recognises selling profit or loss on a **finance lease**, regardless of whether the lessor transfers the underlying asset as described under Ind AS 115. Costs incurred by a manufacturer or dealer lessor in connection with obtaining a finance lease are recognised as an expense at the commencement date and are **excluded** from the net investment in the lease because they are mainly related to earning the manufacturer or dealer's selling profit.

Accounting for initial direct costs shall be done in the following manner:

By Lessor
Finance Lease: Ind AS 116 requires 'lessors' (*other than manufacturer or dealer lessors*) to include initial direct costs in the initial measurement of their net investments in finance leases and reduce the amount of income recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease and they are not added separately. (*Initial direct costs related to finance leases incurred by manufacturer or dealer lessors are expensed at lease commencement*). **Operating Lease:** Ind AS 116 requires lessors to include initial direct costs in the carrying amount of the underlying asset in an operating lease. These initial direct costs are recognised as an expense over the lease term on the same basis as lease income.

3.5.2.4 Subsequent Measurement

After lease commencement, a lessor accounts for a finance lease, as follows:

- Recognises **finance income** (in profit or loss) over the lease term in an amount that produces a constant periodic rate of return on the remaining balance of the net investment in the lease (i.e., using the interest rate implicit in the lease).
  - Income is recognised on the components of the net investment in the lease, which is Interest on the lease receivables.
- Reduces the net investment in the lease for lease payments received (net of finance income calculated above)
- Separately recognises income from variable lease payments that are not included in the net investment in the lease (e.g., performance- or usage-based variable payments) in the period in which that income is earned
- Recognises any impairment of the net investment in the lease

Remeasurement of the net investment in the lease:

After lease commencement, the net investment in a lease is **NOT REMEASURED UNLESS** in either of the following situations:

- The lease is modified (i.e., a change in the scope of the lease, or the consideration for the lease, that was not part of the original terms and conditions of the lease) and the modified lease is not accounted for as a separate contract

OR

- The lease term is revised when there is a change in the non-cancellable period of the lease.

(Refer section 3.5.4 Modification of lease)

Illustration 38 - Lessor accounting for a finance lease → dealer-lessor case

A Lessor enters into a 10-year lease of equipment with Lessee. The equipment is not specialised in nature and is expected to have alternative use to Lessor at the end of the 10-year lease term. Under the lease:

- *Lessor receives annual lease payments of ₹ 15,000, payable at the end of the year*
- *Lessor expects the residual value of the equipment to be ₹ 50,000 at the end of the 10-year lease term*
- *Lessee provides a residual value guarantee that protects Lessor from the first ₹ 30,000 of loss for a sale at a price below the estimated residual value at the end of the lease term (i.e., ₹ 50,000)*

- *The equipment has an estimated remaining economic life of 15 years, a carrying amount of ₹ 1,00,000 and a fair value of ₹ 1,11,000*
- *The lease does not transfer ownership of the underlying asset to Lessee at the end of the lease term or contain an option to purchase the underlying asset*
- *The interest rate implicit in the lease is 10.078%.*

How should the Lessor account for the same in its books of accounts?

Solution:

Lessor shall classify the lease as a **FINANCE LEASE** because the sum of the present value of lease payments amounts to **substantially all** of the fair value of the underlying asset.

At lease commencement, Lessor accounts for the finance lease, as follows:

Net investment in the lease	₹ 1,11,000[(a)]	
Cost of goods sold	₹ 92,340[(b)]	
Revenue		₹ 1,03,340[(c)]
Property held for lease		₹ 1,00,000[(d)]

To record the net investment in the finance lease and derecognise the underlying asset.

(a) The net investment in the lease consists of:

(1) the present value of 10 annual payments of ₹ 15,000 plus the guaranteed residual value of ₹ 30,000, both discounted at the interest rate implicit in the lease, which equals ₹ 1,03,340 (i.e., the lease payment) (Refer note 1) ***AND***

(2) the present value of unguaranteed residual asset of ₹ 20,000, which equals ₹ 7,660 (Refer note 2).

Note that the net investment in the lease is subject to the same considerations as other assets in classification as current or non-current assets in a classified balance sheet.

(b) Cost of goods sold is the carrying amount of the equipment of ₹ 1,00,000 (less) the present value of the unguaranteed residual asset of ₹ 7,660.

(c) Revenue equals the lease receivable.

(d) The carrying amount of the underlying asset.

At lease commencement, Lessor recognises selling profit of ₹ 11,000 which is calculated as = lease payment of ₹ 1,03,340 – [carrying amount of the asset (₹ 1,00,000) – net of any unguaranteed residual asset (₹ 7,660) ie which equals ₹ 92,340]

Year 1 **Journal entry for a finance lease**

Cash	₹ 15,000[(e)]	
Net investment in the lease		₹ 3,813[(f)]
Interest income		₹ 11,187[(g)]

(e) Receipt of annual lease payments at the end of the year.

(f) *Reduction of the net investment in the lease for lease payments received of ₹ 15,000, net of interest income of ₹ 11,187*

(g) *Interest income is the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease. Please refer the computation below:*

The following table summarises the interest income from this lease and the related amortisation of the net investment over the lease term:

Year	Annual Rental Payment	Annual Interest Income (h)	Net investment at the end of the year
Initial net investment	-	-	1,11,000
1	15,000	11,187	1,07,187
2	15,000	10,802	1,02,989
3	15,000	10,379	98,368
4	15,000	9,914	93,282
5	15,000	9,401	87,683
6	15,000	8,837	81,520
7	15,000	8,216	74,736
8	15,000	7,532	67,268
9	15,000	6,779	59,047
10	15,000	5,953	50,000(i)

(h) *Interest income equals 10.078% of the net investment in the lease at the beginning of each year. For e.g., Year 1 annual interest income is calculated as ₹ 1,11,000 (initial net investment) x 10.078%.*

(i) *The estimated residual value of the equipment at the end of the lease term.*

Working Notes:

1 Calculation of net investment in lease:

Year	Lease Payment (A)	Present value factor @ 10.078% (B)	Present value of lease payments (A x B = C)
1	15,000	0.908	13,620
2	15,000	0.825	12,375
3	15,000	0.750	11,250
4	15,000	0.681	10,215
5	15,000	0.619	9,285
6	15,000	0.562	8,430
7	15,000	0.511	7,665
8	15,000	0.464	6,960

9	15,000	0.421	6,315
10	15,000	0.383	5,745
10	30,000	0.383	11,480*
			1,03,340

* Figure has been rounded off for equalization of journal entry.

2 Calculation of present value of unguaranteed residual asset

Year	Lease Payment (A)	Present value factor @ 10.078% (B)	Present value of lease payments (A x B = C)
10	20,000	0.383	7,660

*****

Impairment of the net investment in the lease:

A lessor shall apply the derecognition and impairment requirements in Ind AS 109 to the net investment in the lease. A lessor shall review regularly estimated unguaranteed residual values used in computing the gross investment in the lease. If there has been a reduction in the estimated unguaranteed residual value, the lessor shall revise the income allocation over the lease term and recognise immediately any reduction in respect of amounts accrued.

3.5.3 Operating Leases

3.5.3.1 Recognition and Measurement

A lessor shall recognise lease payments from operating leases as income on either a straight-line basis ***OR*** another systematic basis. The lessor shall apply another systematic basis if that basis is more representative of the pattern in which benefit derived from the use of the underlying asset is diminished.

Lessors subsequently recognise lease payments over the lease term on either a straight-line basis or another systematic and rational basis if that basis better represents the pattern in which benefit is expected to be derived from the use of the underlying asset. After lease commencement, lessors recognise variable lease payments that do not depend on an index or rate (e.g., performance- or usage- based payments) **as they are earned**.

Ind AS 116 also requires lessors of operating leases to **defer** initial direct costs at lease commencement and recognise them over the lease term on the **same basis** as lease income.

3.5.4 Lease Modifications

A '**lease modification**' is a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (***for e.g.***, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term).

3.5.4.1 Finance Lease Modification

Modification- Separate lease:

A lease modification is accounted for as a separate lease if both:

(a) The modification increases the scope of the lease by adding the right to use one or more underlying assets; **and**

(b) The consideration for the lease increases by an amount commensurate with the standalone price for the increase in scope.

If both criteria are met, a lessor would follow the existing lessor guidance on initial recognition and measurement.

Modification- Not Separate lease:

If a lease modification fails the test to be considered as separate lease as mentioned above, the lessor follows the following guidance:

The lease would have been classified as operating with the modifications at the inception date	• Account for the lease modification as a new lease from the effective date of the modification; and • Measure the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the lease modification.
All other lease modification	• Apply the requirements of Ind AS 109 Financial Instruments.

The re-measurements above occur as of the effective date of the lease modification on a prospective basis.

3.5.4.2 Operating Lease Modification:

A lessor shall account for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease.

3.5.5 Presentation

Lessors have the following presentation requirements under Ind AS 116, depending on the classification of the leases:

Finance Leases	*Operating Leases*
Lessors recognise assets held under a **finance lease** in the balance sheet and present them as a receivable at an amount equal to the net investment in the lease under Ind AS 116. In addition, the net investment in the lease is subject to the **same considerations** as other assets in classification as current or non-current assets in a classified balance sheet.	Lessors are required to present underlying assets subject to **operating leases** according to the nature of that asset in the balance sheet under Ind AS 116.

3.5.6 Disclosure

The objective of the disclosure requirements for lessors to disclose information in the notes that together with the information provided in the balance sheet, statement of profit or loss and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessor.

The lessor disclosure requirements in Ind AS 116 are more extensive to enable users of financial statements to better evaluate the amount, timing and uncertainty of cash flows arising from a lessor's leasing activities.

Following are the disclosure requirements under Ind AS 116 for lessors:

Quantitative Disclosure Requirements	
Finance leases	– Selling profit or loss; – Finance income on the net investment; – Income from variable lease payments; – Qualitative and quantitative explanation of changes in the net investment; and – Maturity analysis of lease payments receivable.
Operating leases	– Lease income, separately disclosing variable lease payments; – Disclosure requirements of Ind AS 16 for leased assets, separating leased assets from non-leased assets; – Other applicable disclosure requirements based on the nature of the underlying asset (eg. Ind AS 36, Ind AS 38, Ind AS 40 and Ind AS 41); and – Maturity analysis of lease payments.

The standard prescribes that the quantitative disclosures should be presented in a tabular format, unless another format is more appropriate to be presented.

Qualitative Disclosure Requirements

Similar to the lessee disclosure requirements, Ind AS 16 requires a lessor to disclose additional qualitative and quantitative information about its leasing activities in order to provide users with a basis for assessing the leasing's impact on the financial statements.

This disclosure would include the nature of the lessor's leasing activities and how the lessee manages risks associated with those activities, including risk management on rights retained in underlying assets and risk management strategies including:

– Buy-back agreements;

– Residual value guarantees;

– Variable lease payments for excess use; and

– Any other risk management strategies.

3.6 OTHER MATTERS

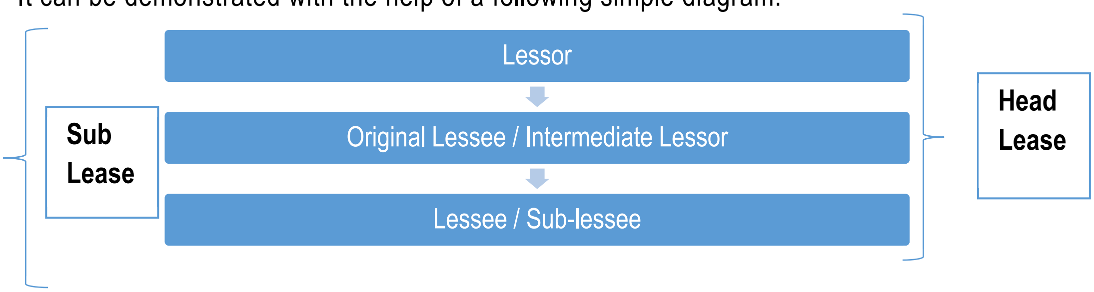
3.6.1 Sub-Leases

3.6.1.1 Recognition and Measurement

A 'Sub-lease' is defined as a transaction for which an underlying asset is re-leased by a lessee ('intermediate lessor') to a third party, and the lease ('head lease') between the head lessor and lessee remains in effect.

Lessees often enter into arrangements to sublease a leased asset to a third party while the original lease contract is in effect, where, one party acts as both the lessee and lessor of the same underlying asset. The original lease is often referred to as a 'head lease', the original lessee is often referred to as an 'intermediate lessor' or 'sub-lessor' and the ultimate lessee is often referred to as the 'sub-lessee'.

It can be demonstrated with the help of a following simple diagram:



In some cases, the sublease is a separate lease agreement while, in other cases, a third party assumes the original lease but, the original lessee remains the primary obligor under the original lease.

Intermediate Lessor Accounting:

Where an underlying asset is re-leased by a lessee to a third party and the original lessee retains the primary obligation under the original lease, the transaction is a sublease, i.e., the original lessee generally continues to account for the original lease (the head lease) as a lessee and accounts for the sublease as the lessor (intermediate lessor).

When the head lease is a short-term lease, the sublease is classified as an operating lease. Otherwise, the sublease is classified using the classification criteria (as discussed earlier) BUT, it should be by reference to the 'ROU Asset' in the head lease (and NOT the 'underlying asset' of the head lease). This can be understood better with the help of a following illustration:

Illustration 39 - Classification of a sublease in case of an Intermediate Lessor

Entity ABC (original lessee/intermediate lessor) leases a building for five years. The building has an economic life of 40 years. Entity ABC subleases the building for four years.

How should the said sublease be classified by Entity ABC?

Solution:

The sublease is classified with reference to the 'ROU Asset' in the head lease (and **NOT** the 'underlying building' of the head lease). Hence, when assessing the useful life criterion, the sublease term of four years is compared with five-year ROU Asset in the head lease (**NOT** compared with 40-year economic life of the building) and accordingly may result in the sublease being classified as a finance lease.

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The intermediate lessor accounts for the sublease as follows:

If the sublease is classified as a 'Finance Lease'	***If the sublease is classified as an 'Operating Lease'***
The original lessee derecognises the ROU Asset on the head lease at the sublease commencement date and continues to account for the original lease liability in accordance with the lessee accounting model. The original lessee (as the intermediate lessor) recognises a net investment in the sublease and evaluates it for impairment.	The original lessee continues to account for the lease liability and ROU asset on the head lease like any other lease. If the total remaining carrying amount of the ROU asset on the head lease exceeds the anticipated sublease income, this may indicate that the ROU asset associated with the head lease is impaired (which is assessed for impairment under Ind AS 36).

In a sublease, an intermediate lessor may use the discount rate for the head lease (**adjusted for initial direct costs, if any, associated with the sublease**) to measure the net investment in the sublease, if the interest rate implicit in the lease cannot be readily determined.

When contracts are entered into at or near the same time, an intermediate lessor is required to consider the criteria for **combining contracts** (***for e.g.***, when the contracts are negotiated as a package with a single commercial objective, or when the consideration to be paid in one contract depends on the price or performance of the other contract). If the contracts are required to be combined, the intermediate lessor accounts for the head lease and sublease as a **single combined transaction**.

An intermediate lessor who subleases, or expects to sublease an asset, **CANNOT** account for the head lease as a lease of a low-value asset **even when** the required criteria w.r.t. 'leases of low-value assets' (as discussed earlier) are satisfied.

Let us consider some more examples with regards to applying the requirements of Ind AS 116 to an intermediate lessor that enters into a head lease and a sublease of the same underlying asset:

Illustration 40 - Intermediate Lessor – Where the sublease is classified as a 'Finance Lease'

Head lease:

An intermediate lessor enters into a five-year lease for 10,000 square metres of office space (the head lease) with Entity XYZ (the head lessor).

Sublease:

At the beginning of Year 3, the intermediate lessor subleases the 10,000 square metres of office space for the remaining lease term i.e three years of the head lease to a sub-lessee.

How should the said sublease be classified and accounted for by the Intermediate Lessor?

Solution:

The intermediate lessor classifies the sublease by reference to the ROU Asset arising from the head lease (i.e., in this case, comparing the three-year sublease with the five-year ROU Asset in the head lease). The intermediate lessor classifies the sublease as a finance lease, having considered the requirements of Ind AS 116 (i.e., one of the criteria of 'useful life' for a lease to be classified as a finance lease).

When the intermediate lessor **enters into** a sublease, the intermediate lessor:

(i) derecognises the ROU asset relating to the head lease that it transfers to the sublessee and recognises the net investment in the sublease;

(ii) recognises any difference between the ROU asset and the net investment in the sublease in profit or loss; ***AND***

(iii) retains the lease liability relating to the head lease in its balance sheet, which represents the lease payments owed to the head lessor.

<u>During the term</u> of the sublease, the intermediate lessor recognises both

- finance income on the sublease ***AND***
- interest expense on the head lease.

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Illustration 41 - Intermediate Lessor – Where the sublease is classified as a 'Operating Lease'

Head lease:

An intermediate lessor enters into a five-year lease for 10,000 square metres of office space (the head lease) with Entity XYZ (the head lessor).

Sublease:

At the commencement of the head lease, the intermediate lessor subleases the 10,000 square metres of office space for two years to a sub-lessee.

How should the said sublease be classified and accounted for by the Intermediate Lessor?

Solution:

The intermediate lessor classifies the sublease by reference to the ROU Asset arising from the head lease (i.e., in this case, comparing the two-year sublease with the five-year ROU Asset in the head lease). The intermediate lessor classifies the sublease as an operating lease, having considered the requirements of Ind AS 116 (i.e., one of the criteria of 'useful life' for a lease to be classified as a finance lease and since, it is not satisfied, classified the same as an operating lease).

When the intermediate lessor **<u>enters into</u>** the sublease, the intermediate lessor retains:

- the lease liability ***AND***
- the ROU asset

both relating to the head lease in its balance sheet.

<u>During the term</u> of the sublease, the intermediate lessor:

(a) recognises a depreciation charge for the ROU asset and interest on the lease liability; ***AND***

(b) recognises lease income from the sublease.

<u>Sub-lessee Accounting:</u>

A sub-lessee accounts for its lease in the same manner as any other lease (i.e., as a new lease subject to Ind AS 116's recognition and measurement provisions).

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3.6.1.2 Presentation

According to paragraph 32 of Ind AS 1, *Presentation of Financial Statements*, an entity **cannot offset** assets and liabilities or income and expenses, **unless** required or permitted by an Ind AS.

Thus, intermediate lessors are **not permitted** to offset lease liabilities and lease assets that arise from a head lease and a sublease, respectively, **unless** those liabilities and assets meet the requirements in Ind AS 1 for offsetting.

Similarly, intermediate lessors are **not permitted** to offset depreciation and interest expenses and lease income relating to a head lease and a sublease of the same underlying asset, respectively, **unless** the requirements for offsetting in Ind AS 1 are met.

3.6.1.3 Disclosure

Under Ind AS 116, entities (**including intermediate lessors**) are required to disclose **qualitative** and **quantitative** information which gives a **basis** for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessor (refer the disclosures for 'lessors' and 'lessees' already discussed earlier).

3.6.2 Sale and Leaseback Transactions

A sale and leaseback transaction involves the transfer of an asset by an entity (the seller-lessee) to another entity (the buyer-lessor) and the leaseback of the same asset by the seller-lessee.

Sale and leaseback transactions would no longer provide lessees with a source of off-balance sheet financing because under Ind AS 116, lessees are required to recognise most leases on the balance sheet (i.e., all leases **except** for leases of low-value assets and short-term leases depending on the lessee's accounting policy election).

Further, both the seller-lessee and the buyer-lessor are required to apply Ind AS 115 to determine whether to account for a sale and leaseback transaction as a sale and purchase of an asset.

How to determine whether the transfer of an asset is a sale:

As discussed above, when determining whether the transfer of an asset should be accounted for as a sale or purchase, both the seller-lessee and the buyer-lessor shall apply the requirements of Ind AS 115 on when an entity satisfies a performance obligation by transferring **'control'** of an asset. Thus, there are following two possibilities in this scenario:

If Control is passed	*If Control is NOT passed*
If the control of an underlying asset is **passed** to the buyer-lessor, the transaction is accounted for as a **'sale or purchase'** of the asset and a **'lease'**.	If the control of an underlying asset is **NOT passed** to the buyer-lessor, both the seller-lessee and the buyer-lessor account for the transaction as a **'financing transaction'**.

None of the indicators mentioned under Ind AS 115 individually determine whether the buyer-lessor has obtained control of the underlying asset and thus, both the seller-lessee and the buyer-lessor must consider **all relevant facts and circumstances** to determine whether control has been transferred. Further, **not all of the indicators must be present** to determine that the buyer-lessor has gained control rather, said indicators are the factors that are often present when a customer has obtained control of an asset and the said list is meant to help entities to apply the principle of control.

The existence of a leaseback, **in isolation**, does **NOT preclude a sale** because a lease is different from the sale or purchase of an underlying asset, since a lease does **not transfer 'control'** of the underlying asset. Instead, a lease **transfers the 'right to control'** the use of the underlying asset for the period of the lease.

However, if the seller-lessee has a **'substantive repurchase option'** for the underlying asset (i.e., a right to repurchase the asset), **'NO sale'** has occurred because the buyer-lessor has **NOT** obtained control of the asset.

Transactions in which the transfer of an asset is a 'SALE':

If the transfer of an asset by the seller-lessee satisfies the requirements of Ind AS 115 to be accounted for as a 'sale' of the asset:

<table>
<tr><th>Seller-lessee</th><th>Buyer-lessor</th></tr>
<tr><td>The seller-lessee shall measure the ROU asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee shall recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor.

Thus, the seller-lessee will:

- Derecognise the underlying asset

- Recognise the gain or loss, if any, that relates to the rights transferred to the buyer-lessor (adjusted for off-market terms)</td><td>The buyer-lessor shall account for the purchase of the asset, applying applicable Ind ASs and for the lease, applying the lessor accounting requirements under Ind AS 116.

Thus, a buyer-lessor accounts for the purchase of the asset in accordance with other Ind ASs based on the nature of the asset (for e.g., Ind AS 16 for property, plant and equipment).</td></tr>
<tr><td colspan="2">When a sale occurs, both the seller-lessee and the buyer-lessor account for the leaseback in the same manner as any other lease (with adjustments for any off-market terms). Specifically, a seller-lessee recognises a lease liability and ROU asset for the leaseback (subject to the optional exemptions for short-term leases and leases of low-value assets).</td></tr>
</table>

An entity shall make the following adjustments to measure the sale proceeds at fair value if:

- the fair value of the consideration for the sale of an asset does not equal the fair value of the asset ***OR***
- the payments for the lease are not at market rates:
  (a) any **below**-market terms shall be accounted for as a prepayment of lease payments; ***AND***
  (b) any **above**-market terms shall be accounted for as an additional financing provided by the buyer-lessor to the seller-lessee.

The entity shall measure any potential adjustment ('a' or 'b' - as described above) on the basis of the following (whichever is more readily determinable):

(a) the difference between the **fair value** of the consideration for the sale and the **fair value** of the asset; ***OR***

(b) the difference between the **present value** of the contractual payments for the lease and the **present value** of payments for the lease at market rates.

The sale transaction and the resulting lease are **generally interdependent and negotiated as a package**. Consequently, some transactions could be structured with a negotiated sales price that is above or below the asset's fair value and with lease payments for the resulting lease that are above or below the market rates. These off-market terms could mislead / falsify the gain or loss on the sale and the recognition of lease expense and lease income for the lease. Thus, to ensure that the gain or loss on the sale and the lease-related assets and liabilities associated with such transactions are **NEITHER understated NOR overstated**, Ind AS 116 requires **adjustments for any off-market terms** of sale and leaseback transactions, on the **more readily determinable basis** (as discussed above). Thus, the two possibilities of the sale price ***OR*** the present value of the lease payments being 'less' or 'greater' than the fair value of the asset ***OR*** present value of the market lease payments, respectively, is discussed in detail:

When sale price or Present Value is LESS	***When sale price or Present Value is GREATER***
Using the more readily determinable basis: When the sale price is **LESS** than the underlying asset's fair value ***OR*** the present value of the lease payments is **LESS** than the present value of the market lease payments, a seller-lessee recognises the difference as an **increase** to the sales price and the	Using the more readily determinable basis: When the sale price is **GREATER** than the underlying asset's fair value ***OR*** the present value of the lease payments is **GREATER** than the present value of the market lease payments, a seller-lessee recognises the difference as a **reduction** in the sales price and an **'additional**

initial measurement of the ROU asset as a **'lease prepayment'**.	**financing received'** from the buyer-lessor.
Buyer-lessors are also required to **adjust the purchase price** of the underlying asset for any off-market terms. Such adjustments are recognised as: - **'lease prepayments'** made by the seller-lessee ***OR*** - **'additional financing provided'** to the seller-lessee.	

Let us consider an illustration to understand the accounting for a sale and leaseback transaction:

Illustration 42 - Sale and leaseback transaction

An entity (Seller-lessee) sells a building to another entity (Buyer-lessor) for cash of ₹ 30,00,000. Immediately before the transaction, the building is carried at a cost of ₹ 15,00,000. At the same time, Seller-lessee enters into a contract with Buyer-lessor for the right to use the building for 20 years, with annual payments of ₹ 2,00,000 payable at the end of each year.

The terms and conditions of the transaction are such that the transfer of the building by Seller-lessee satisfies the requirements for determining when a performance obligation is satisfied in Ind AS 115 Revenue from Contracts with Customers.

The fair value of the building at the date of sale is ₹ 27,00,000. Initial direct costs, if any, are to be ignored. The interest rate implicit in the lease is 12% p.a., which is readily determinable by Seller-lessee.

Buyer-lessor classifies the lease of the building as an operating lease.

How should the said transaction be accounted by the Seller-lessee and the Buyer-lessor?

Solution:

Considering facts of the case, Seller-lessee and buyer-lessor account for the transaction as a sale and leaseback.

Firstly, since the consideration for the sale of the building is not at fair value, Seller-lessee and Buyer - lessor make adjustments to measure the sale proceeds at fair value. Thus, the amount of the excess sale price of ₹ 3,00,000 (as calculated below) is recognised as additional financing provided by Buyer-lessor to Seller-lessee.

Sale Price:	30,00,000
Less: Fair Value (at the date of sale):	(27,00,000)
Additional financing provided by Buyer-lessor to Seller-lessee	**3,00,000**

Next step would be to calculate the present value of the annual payments which amounts to ₹ 14,94,000 (calculated considering 20 payments of ₹ 2,00,000 each, discounted at 12% p.a.) of which ₹ 3,00,000 relates to the additional financing (as calculated above) and balance

₹ 11,94,000 relates to the lease — corresponding to 20 annual payments of ₹ 40,164 and ₹ 1,59,836, respectively (refer calculations below).

Proportion of annual lease payments:

Present value of lease payments (as calculated above)	(A)	14,94,000
Additional financing provided (as calculated above)	(B)	3,00,000
Relating to the Additional financing provided	(C) = (E x B / A)	40,160
Relating to the Lease	(D) = (E – C)	1,59,840
Annual payments (at the end of each year)	(E)	2,00,000

Seller-Lessee:

At the commencement date, Seller-lessee measures the ROU asset arising from the leaseback of the building at the proportion of the previous carrying amount of the building that relates to the right-of-use retained by Seller-lessee, calculated as follows:

Carrying Amount	(A)	15,00,000
Fair Value (at the date of sale)	(B)	27,00,000
Discounted lease payments for the 20-year ROU asset	(C)	11,94,000
ROU Asset	**[(A / B) x C]**	**6,63,333**

Seller-lessee recognises only the amount of the gain that relates to the rights transferred to Buyer-lessor, calculated as follows:

Fair Value (at the date of sale)	(A)	27,00,000
Carrying Amount	(B)	15,00,000
Discounted lease payments for the 20-year ROU asset	(C)	11,94,000
Gain on sale of building	**(D) = (A - B)**	**12,00,000**
Relating to the right to use the building retained by Seller-lessee	(E) = [(D / A) x C]	5,30,667
Relating to the rights transferred to Buyer-lessor	(D - E)	6,69,333

At the commencement date, Seller-lessee accounts for the transaction, as follows:

Cash	Dr.	30,00,000	
ROU Asset	Dr.	6,63,333	
To Building			15,00,000
To Financial Liability			14,94,000
To Gain on rights transferred			6,69,333

Buyer-Lessor:

At the commencement date, Buyer-lessor accounts for the transaction, as follows:

Building Dr.	27,00,000	
Financial Asset (20 payments of ₹ 40,160 discounted @ 12% p.a.) (approx.) Dr.	3,00,000	
To Cash		30,00,000

After the commencement date, Buyer-lessor accounts for the lease by treating ₹ 1,59,840 of the annual payments of ₹ 2,00,000 as lease payments. The remaining ₹ 40,160 of annual payments received from Seller-lessee are accounted for as:

(a) payments received to settle the financial asset of ₹ 3,00,000 ***AND***

(b) interest revenue.

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Transactions in which the transfer of an asset is 'NOT a SALE':

If the transfer of an asset by the seller-lessee does not satisfy the requirements of Ind AS 115 to be accounted for as a 'sale' of the asset:

Seller-lessee	*Buyer-lessor*
The seller-lessee shall **continue** to recognise the transferred asset and shall recognise a financial liability **equal** to the transfer proceeds. It shall account for the financial liability applying Ind AS 109. Thus, the seller-lessee accounts for the transaction as a **financing transaction**. The seller-lessee keeps the transferred asset subject to the sale and leaseback transaction on its balance sheet and accounts for amounts received as a **financial liability** in accordance with Ind AS 109. The seller-lessee decreases the financial liability by the payments made less the portion considered as interest expense.	The buyer-lessor shall **not** recognise the transferred asset and shall recognise a financial asset **equal** to the transfer proceeds. It shall account for the financial asset applying Ind AS 109. Thus, the buyer-lessor does **not recognise** the transferred asset and accounts for the amounts paid as a **receivable** in accordance with Ind AS 109.

Disclosures:

A seller-lessee may be required to provide additional qualitative and quantitative information about its leasing activities that is necessary to meet the disclosure objective in Ind AS 116.

A seller-lessee is also required to disclose any gains and losses arising from sale and leaseback transaction separately from gains and losses on disposals of other assets under Ind AS 116. Thus, additional information relating to sale and leaseback transactions that, depending on the circumstances, may be needed to satisfy the disclosure objective in Ind AS 116, could include information that helps users of financial statements to assess, ***for e.g.***:

(a) The lessee's reasons for sale and leaseback transactions and the prevalence of those transactions	(b) Key terms and conditions of individual sale and leaseback transactions
(c) Payments not included in the measurement of lease liabilities	(d) The cash flow effect of sale and leaseback transactions in the reporting period

3.7 TRANSITION APPROACH

An entity shall apply Ind AS 116 for annual reporting periods beginning on or after ***01 April 2019***.

For the purposes of the requirements of this 'Transition' section, the **date of initial application** is the **beginning of the annual reporting period** in which an entity first applies Ind AS 116.

Thus, Ind AS 116's transition provisions are applied at the beginning of the annual reporting period in which the entity first applies Ind AS 116 (i.e., the date of initial application). ***For e.g.***, an entity with a reporting date of 31 March 2020, applies the transition provisions on 01 April 2019.

3.7.1 Definition of a Lease

There is a practical expedient provided which permits lessees and lessors to make an election of not reassessing whether existing contracts contain a lease as defined under Ind AS 116.

Thus, if an entity elects this practical expedient, contracts that do not contain a lease under Ind AS 17 (including those under Appendix C to Ind AS 17, *Determining whether an Arrangement contains a Lease*) are not reassessed either. This practical expedient has been provided because if the entities are required to reassess existing contracts by applying the lease definition guidance in Ind AS 116, probably it would not justify the costs/complexity.

Further, if an entity chooses to apply the practical expedient, it must be applied to ***ALL*** contracts that are ongoing at the date of initial application (i.e., an entity is ***NOT*** permitted to apply the option on a lease-by-lease basis) and that fact shall also be disclosed.

3.7.2 Transition Options for Lessees

A lessee is required to apply Ind AS 116 to its leases in either of the following ways:

Full Retrospective Approach	***Modified Retrospective Approach***
Retrospectively to each prior reporting period presented, applying Ind AS 8, i.e., an entity applies Ind AS 116 as if it had been applied since the inception of all lease contracts that are presented in the financial statements. If Ind AS 116 is applied at 01 April 2019, this means that, in the 31 March 2020 financial statements, the comparative period to 31 March 2019 must be restated (assuming that this is the only comparative period presented). A restated opening balance sheet at 01 April 2018 will also need to be disclosed as required by Ind AS 1. Hence, the balance sheets for 3 period will be presented: As at 31 March 2020, 31 March 2019 & 1 April 2018.	Retrospectively with cumulative effect of initially applying Ind AS 116 recognised as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of the initial application. Therefore, restatement of comparatives is not required and only Balance sheets for reporting date and comparative date is required to be presented.

A lessee shall apply the elected transition approach consistently to ***ALL*** leases in which it is lessee.

3.7.3 Modified Retrospective Approach

3.7.3.1 Leases Previously Classified as Operating Leases

When **applying the modified retrospective approach**, a lessee does not restate comparative figures rather, a lessee recognises the cumulative effect of initially applying Ind AS 116 as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application.

For leases previously classified as operating leases under Ind AS 17, a lessee recognises a lease liability measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application. A lessee measures the ROU asset on a **lease-by-lease basis**, at either:

- Its carrying amount as if Ind AS 116 had always been applied since the commencement date, but using a discount rate based on the lessee's incremental borrowing rate at the date of initial application (Alternative 1)

OR

- An amount equal to the lease liability, adjusted for previously recognised prepaid or accrued lease payments (Alternative 2)

A lessee applies Ind AS 36 to ROU assets at the date of initial application, unless the lessee applies the practical expedient for onerous leases (as discussed below).

A lessee is not required to make adjustments on transition for 'leases of low-value assets' (which is one of the recognition exemptions under Ind AS 116 – as discussed earlier).

Additionally, a lessee is also permitted to apply the following practical expedients to leases previously classified as operating leases (when applying modified retrospective approach), on a **<u>lease-by-lease basis</u>**:

Discount rate	• Apply a single discount rate to a portfolio of leases with reasonably similar characteristics;
Onerous contracts	• Rely on its assessment of whether leases are onerous by applying Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets as opposed to performing an impairment review;
Short term leases	• Not recognise leases whose term ends within 12 months of the date of initial application of Ind AS 116. If this election is taken, these leases are accounted for as short-term leases;
Initial direct cost	• Exclude initial direct costs from the measurement of right-of-use assets at the date of initial application;
Hindsight	• Use hindsight, such as in determining the lease term for leases that contain options

Ind AS 116 is silent on as to how a lessee would separate and allocate lease and non-lease components of a contract upon transition when the modified retrospective approach is adopted. So, lessees could allocate the consideration in the contract (determined at lease commencement) to each lease and non-lease component on the basis of the relative stand-alone price of the lease component on that same date unless the lessee elects to use the practical expedient to account for each lease component and any associated non-lease components as a 'single lease component' (as discussed earlier).

3.7.3.2 Leases Previously Classified as Finance Leases

When applying modified retrospective approach, for leases that were classified as finance leases applying Ind AS 17, the carrying amount of the ROU asset and the lease liability at the date of initial application shall be the carrying amount of the lease asset and lease liability immediately before that date measured applying Ind AS 17. For such leases, a lessee shall account for the ROU asset and the lease liability applying Ind AS 116 from the date of initial application. Thus, a lessee will not change its initial carrying amounts for assets and liabilities under finance leases existing at the date of initial application of Ind AS 116.

For leases previously classified as operating leases and finance leases, the below table summarises the application of Modified retrospective approach:

Operating Lease	**Lease liability**	**Measure at the present value of the remaining lease payments, discounted using lessee's incremental borrowing rate at the date of initial application**
	Right-of-use asset	Retrospective calculation, using a discount rate based on lessee's incremental borrowing rate at the date of initial application. or Amount of lease liability (adjusted by the amount of any previously recognised prepaid or accrued lease payments relating to that lease). Lessee can choose one of the alternatives on a lease-by-lease basis.
Finance Lease	Lease liability	Carrying amount of the lease liability immediately before the date of initial application.
	Right-of-use asset	Carrying amount of the lease asset immediately before the date of initial application.
	Application of Ind AS 116	Apply the provisions of this standard to Right of Use asset and lease liability from the date of initial application.

The standard also prescribes certain practical expedients under Modified retrospective approach to leases previously classified as operating leases applying Ind AS 17.

Let us consider an illustration to understand the transition approaches in a more precise manner:

Illustration 43 - Transition Approaches

A retailer (lessee) entered into 3-year lease of retail space beginning at 1 April 2017 with three annual lease payments of ₹ 2,00,000 due on 31 March 2018, 2019 and 2020, respectively. The lease is classified as an operating lease under Ind AS 17. The retailer initially applies Ind AS 116 *for the first time in the annual period beginning at 1 April 2019. The incremental borrowing rate at the date of the initial application (i.e., 1 April 2019) is 10% p.a. and at the commencement of the lease (i.e., 1 April 2017) was 12% p.a. The ROU asset is subject to straight-line depreciation over the lease term. Assume that no practical expedients are elected, the lessee did not incur initial direct costs, there were no lease incentives and there were no requirements for the lessee to dismantle and remove the underlying asset, restore the site on which it is located or restore the underlying asset to the condition under the terms and conditions of the lease.*

What would be the impact for the lessee using all the following transition approaches:

Full Retrospective Approach

Modified Retrospective Approach

- Alternative 1

- Alternative 2

Solution:

Full Retrospective Approach:

Under the full retrospective approach, the lease liability and the ROU asset are measured on the commencement date (i.e., 1 April 2017 in this case) using the incremental borrowing rate **at lease commencement date** (i.e., 12% p.a. in this case). The lease liability is accounted for by the interest method subsequently and the ROU asset is subject to depreciation on the straight-line basis over the lease term of three years. Let us first calculate the Lease Liability and ROU Asset as follows:

Year	Payments (Cash flows)	Present Value Factor @12%	Discounted Cash flows / Present Value
31 Mar 2018	2,00,000	0.8929	1,78,580
31 Mar 2019	2,00,000	0.7972	1,59,440
31 Mar 2020	2,00,000	0.7118	1,42,360
	6,00,000		**4,80,380**

Lease Liability Schedule:

Year	Opening	Interest Expense @ 12%	Payments	Closing
31 Mar 2018	4,80,380	57,646	(2,00,000)	3,38,026
31 Mar 2019	3,38,026	40,563	(2,00,000)	1,78,589
31 Mar 2020	1,78,589	21,411*	(2,00,000)	-

*Difference is due to approximation

ROU Asset Schedule:

Year	Opening	Depreciation	Closing
31 Mar 2018	4,80,380	(1,60,126)	3,20,254
31 Mar 2019	3,20,254	(1,60,127)	1,60,127
31 Mar 2020	1,60,127	(1,60,127)	-

The following table shows account balances under this method beginning at lease commencement:

Date	ROU Asset	Lease Liability	Interest Expense	Depreciation Expense	Retained Earnings
01 Apr 2017	4,80,380	4,80,380	-	-	-
31 Mar 2018	3,20,254	3,38,026	-	-	-
01 Apr 2018	3,20,254	3,38,026			(17,772)
31 Mar 2019	1,60,127	1,78,589	40,563	1,60,127	-
01 Apr 2019	1,60,127	1,78,589	-	-	-
31 Mar 2020	-	-	21,411	1,60,127	-

Ind AS 116 is applicable for the financial year beginning from 1st April 2019. Hence, 2019-20 is the first year of adoption and using Full retrospective method the comparative for 2018-19 needs to be restated and 1st April 2018 (i.e the opening of the comparative) is taken as transition date for adoption of this standard. At adoption, the lessee would record the ROU asset and lease liability at the 1 April 2018 by taking values from the above table, with the difference between the ROU asset and lease liability going to retained earnings as of 1 April 2018 (assuming that only the 2018-19 financial information is included as comparatives).

ROU Asset	Dr.	3,20,254	
Retained Earnings	Dr.	17,772	
To Lease Liability			3,38,026
To initially recognise the lease-related asset and liability as of 1 April 2018.			

The following journal entries would be recorded during 2018-19:

Interest expense	Dr.	40,563	
To Lease Liability			40,563
To record interest expense and accrete the lease liability using the interest method.			
Depreciation expense	Dr.	1,60,127	
To ROU Asset			1,60,127
To record depreciation expense on the ROU asset.			

Lease Liability Dr.	2,00,000	
To Cash		2,00,000
To record lease payment.		

The following journal entries would be recorded during 2019-20:

Interest expense Dr.	21,411	
To Lease Liability		21,411
To record interest expense and accrete the lease liability using the interest method.		

Depreciation expense Dr.	1,60,127	
To ROU Asset		1,60,127
To record depreciation expense on the ROU asset.		

Lease Liability Dr.	2,00,000	
To Cash		2,00,000
To record lease payment.		

Modified Retrospective Approach (Alternative 1):

Under the modified retrospective approach (Alternative 1), the lease liability is measured based on the remaining lease payments (i.e., from the date of transition to the lease end date, viz., 01 April 2019 to 31 March 2020 in this case) discounted using the incremental borrowing rate as of the date of initial **application being 01 April 2019** (i.e. 10% p.a. in this case). The ROU asset is at its carrying amount as if Ind AS 116 had been applied since the commencement date (i.e., 01 April 2017 in this case) by using incremental borrowing rate as at transition date. Let us first calculate the Lease Liability and ROU Asset as follows:

Year	*Payments (Cash flows)*	*Discounting Factor @10%*	*Discounted Cash flows / Present Value*
31 Mar 2020	2,00,000	0.9091	1,81,820
	2,00,000		**1,81,820**

Lease Liability Schedule:

Year	*Opening Balance*	*Interest Expense @ 10%*	*Payments*	*Closing Balance*
31 Mar 2020	1,81,820	18,182	(2,00,000)	-

ROU Asset Schedule:

Year	Opening Balance	Depreciation	Closing Balance
31 Mar 2020	1,65,790***	(1,65,790)	-

***(Refer note no 3)

The following table shows account balances under this method beginning at lease commencement:

Date	ROU Asset	Lease Liability	Interest Expense	Depreciation Expense	Retained Earnings
01 Apr 2017	4,97,360*	4,97,360**	-	-	-
31 Mar 2018	3,31,574	3,47,096	49,737	1,65,786	-
31 Mar 2019	1,65,787	1,81,806	34,710	1,65,787	(16,019)
01 Apr 2019	1,65,787	1,81,806	-	-	-
31 Mar 2020	-	-	18,194	1,65,787	-

*(Refer note no 1)

**(Refer note no 2)

At adoption, the lessee would record the ROU asset and lease liability at the 1 April 2019 by taking values from the above table, with the difference between the ROU asset and lease liability going to retained earnings as of 1 April 2019.

ROU Asset	Dr.	1,65,787	
Retained Earnings	Dr.	16,019	
To Lease Liability			1,81,806
To initially recognise the lease-related asset and liability as of 1 April 2019.			

The following journal entries would be recorded during 2019-20:

Interest expense	Dr.	18,182	
To Lease Liability			18,182
To record interest expense and accrete the lease liability using the interest method.			

Depreciation expense	Dr.	1,65,787	
To ROU Asset			1,65,787
To record depreciation expense on the ROU asset.			

Lease Liability Dr.		2,00,000	
To Cash			2,00,000
To record lease payment.			

Note 1:

Calculation of Present value of lease payments as at commencement date i.e., 01/04/2017

Year	*Payments (Cash flows)*	*Discounting Factor @10%*	*Discounted Cash flows / Present Value*
31 Mar 2018	2,00,000	0.9091	1,81,820
31 Mar 2019	2,00,000	0.8264	1,65,280
31 Mar 2020	2,00,000	0.7513	1,50,260
	6,00,000		**4,97,360**

Lease Liability Schedule:

Year	*Opening*	*Interest Expense @ 10%*	*Payments*	*Closing*
31 Mar 2018	4,97,360	49,736	(2,00,000)	3,47,096
31 Mar 2019	3,47,096	34,710	(2,00,000)	1,81,806
31 Mar 2020	1,81,806	18,194*	(2,00,000)	-

*Difference is due to approximation

Calculation of ROU asset as at transition date i.e., April 01, 2019

Year	*Opening*	*Depreciation*	*Closing*
31 Mar 2018	4,97,360	(1,65,786)	3,31,574
31 Mar 2019	3,31,574	(1,65,787)	1,65,787
31 Mar 2020	1,65,787	(1,65,787)	-

Modified Retrospective Approach (Alternative 2):

Under the modified retrospective approach (Alternative 2), the lease liability is also measured based on the remaining lease payments (i.e., from the date of transition to the lease end date, viz., 01 April 2019 to 31 March 2020 in this case) discounted using the incremental borrowing rate as of the date of initial **application being 01 April 2019** (i.e. 10% p.a. in this case). The carrying amount of the ROU asset is an amount equal to the carrying amount of the lease liability on the date of initial application as there are no prepayments or accrual items and hence, no impact on retained earnings as on the transition date. Let us first calculate the Lease Liability and ROU Asset as follows:

Year	Payments (Cash flows)	Discounting Factor @ 10%	Discounted Cash flows / Present Value
31 Mar 2020	2,00,000	0.9091	1,81,820
	2,00,000		**1,81,820**

Lease Liability Schedule:

Year	Opening	Interest Expense	Payments	Closing
31 Mar 2020	1,81,820	18,182	(2,00,000)	-

ROU Asset Schedule:

Year	Opening	Depreciation	Closing
31 Mar 2020	1,81,820	(1,81,820)	-

The following table shows account balances under this method beginning at lease commencement:

Date	ROU Asset	Lease Liability	Interest Expense	Depreciation Expense	Retained Earnings
01 Apr 2019	1,81,820	1,81,820	-	-	-
31 Mar 2020	-	-	18,182	1,81,820	-

At adoption, the lessee would record the ROU asset and lease liability at the 1 April 2019 by taking values from the above table and there will be no impact on retained earnings on the transition date being 1 April 2019 since under this alternative, ROU Asset is equal to the Lease Liability.

ROU Asset	Dr.	1,81,820	
To Lease Liability			1,81,820
To initially recognise the lease-related asset and liability as of 1 April 2019.			

The following journal entries would be recorded during 2019-20:

Interest expense	Dr.	18,182	
To Lease Liability			18,182
To record interest expense and accrete the lease liability using the interest method.			
Depreciation expense	Dr.	1,81,820	
To ROU Asset			1,81,820
To record depreciation expense on the ROU asset.			

Lease Liability	Dr.	2,00,000	
To Cash			2,00,000
To record lease payment.			

A summary of the lease contract's accounting (assuming there are no changes due to reassessments) is, as follows:

Particulars	*Full Retrospective Approach*	*Modified Retrospective Approach (Alternative 1)*	*Modified Retrospective Approach (Alternative 2)*
Opening balance sheet impact as on 1 April 2019:			
ROU Asset	1,60,126	1,65,787	1,81,820
Lease Liability	1,78,589	1,81,806	1,81,820
Period ended 31 March 2020 activity:			
Cash lease payments	2,00,000	2,00,000	2,00,000
Lease payments recognised:			
Interest expense	21,411	18,194	18,182
Depreciation expense	1,60,127	1,65,787	1,81,820
Total periodic expense	1,81,538	1,83,981	2,00,002

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3.7.4 Disclosure

Disclosure requirements vary in accordance with the Transition Approach opted. The lessee shall disclose the following as required by Ind AS 8 (except that it is impracticable to determine the amount of the adjustment):

Full Retrospective Approach	*Modified Retrospective Approach*
(a) the title of the Ind AS; (b) when applicable, that the change in accounting policy is made in accordance with its transitional provisions; (c) the nature of the change in accounting policy;	(a) the title of the Ind AS; (b) when applicable, that the change in accounting policy is made in accordance with its transitional provisions; (c) the nature of the change in accounting policy;

(d) when applicable, a description of the transitional provisions;	(d) when applicable, a description of the transitional provisions;
(e) when applicable, the transitional provisions that might have an effect on future periods;	(e) when applicable, the transitional provisions that might have an effect on future periods;
(f) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment: (i) for each financial statement line item affected; and (ii) if Ind AS 33 *Earnings per Share* applies to the entity, for basic and diluted earnings per share;	(f) the weighted average lessee's incremental borrowing rate applied to lease liabilities recognised in the balance sheet at the date of initial application; and an explanation of any difference between: (i) operating lease commitments disclosed applying Ind AS 17 at the end of the annual reporting period immediately preceding the date of initial application, discounted using the incremental borrowing rate at the date of initial application; and (ii) lease liabilities recognised in the balance sheet at the date of initial application. (g) the amount of the adjustment relating to periods before those presented, to the extent practicable; and
(g) the amount of the adjustment relating to periods before those presented, to the extent practicable; and (h) if retrospective application required by Ind AS 8 is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.	(h) if retrospective application required by Ind AS 8 is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied. Further, if a lessee uses one or more of the practical expedients (already discussed above), it shall disclose that fact.

3.7.5 Lessors

A lessor is not required to make any adjustments on transition for leases in which it is a lessor and shall account for those leases applying Ind AS 116 from the date of initial application **except** in case of an ***'Intermediate Lessor'*** who shall:

(a) reassess subleases that were classified as operating leases applying Ind AS 17 and are ongoing at the date of initial application, to determine whether each sublease should be classified as an operating lease or a finance lease applying Ind AS 116. The intermediate lessor shall perform this assessment at the date of initial application on the basis of the remaining contractual terms and conditions of the head lease and sublease at that date with reference to the ROU Asset associated with the head lease and not the underlying asset.

(b) for subleases that were classified as operating leases applying Ind AS 17 but, finance leases applying Ind AS 116, account for the sublease as a new finance lease entered into at the date of initial application. Any gain or loss arising on the sublease arrangement is included in the cumulative catch-up adjustment to retained earnings at the date of initial application.

3.7.6 Sale and Leaseback Transactions before the date of Initial Application

An entity shall not reassess sale and leaseback transactions entered into before the date of initial application to determine whether the transfer of the underlying asset satisfies the requirements under Ind AS 115 to be accounted for as a sale, i.e., a seller-lessee is prohibited from reassessing historical sale and leaseback transactions to determine whether a sale occurred in accordance with Ind AS 115.

Thus, a seller-lessee does not perform any retrospective adjustments to sale and leaseback transactions on transition to Ind AS 116. Instead, the leaseback is accounted for on transition in the following manner, depending on the classification:

Finance Lease	***Operating Lease***
If a sale and leaseback transaction was accounted for as a sale and a **finance lease** applying Ind AS 17, the seller-lessee shall: (a) account for the leaseback in the same way as it accounts for any other finance lease that exists at the date of initial application ***AND*** (b) continue to amortise any gain on sale over the lease term.	If a sale and leaseback transaction was accounted for as a sale and **operating lease** applying Ind AS 17, the seller-lessee shall: (a) account for the leaseback in the same way as it accounts for any other operating lease that exists at the date of initial application; ***AND*** (b) adjust the leaseback ROU asset for any deferred gains or losses that relate to

	off-market terms recognised in the balance sheet immediately before the date of initial application.

3.7.7 Amounts Previously recognised in respect of Business Combinations

If a lessee previously recognised an asset or a liability applying Ind AS 103 *Business Combinations*, relating to favourable or unfavourable terms of an operating lease acquired as part of a business combination, the lessee shall derecognise that asset or liability and adjust the carrying amount of the ROU asset by a corresponding amount at the date of initial application.

3.8 KEY DIFFERENCES BETWEEN IND AS 17 AND IND AS 116

The significant differences between Ind AS 17 (Earlier Standard on Leases) and Ind AS 116 (New Standard on Leases) are given below:

Sr. No.	*Particulars*	*Ind AS 17*	*Ind AS 116*
1	Lease Definition	A lease is an agreement whereby the lessor conveys to the lessee, in return for a payment or series of payments, the **right to use** an asset for an agreed period of time. Under Appendix C to Ind AS 17 *Determining whether an Arrangement contains a Lease*, it is not necessary for an arrangement to convey the right to control the use of an asset to be in scope of Ind AS 17.	A lease is a contract, or part of a contract, that conveys the **right to control** the use of an asset (the underlying asset) for a period of time in exchange for consideration. To determine if the right to control has been conveyed to the customer, an entity assesses whether, throughout the period of use, the customer has the right to obtain substantially all of the economic benefits from use of the identified asset and **the right to direct the use** of the identified asset.
2	Short-term lease exemption	Ind AS 17 doesn't mention about this.	Lessees can elect to apply a method similar to Ind AS 17 (i.e., operating lease accounting) to leases with a lease term of 12 months or less

			and without a purchase option. This option is available by **<u>'class of underlying asset'</u>** to which the right of use relates.
3	Leases of low-value assets exemption	Ind AS 17 doesn't mention about this.	Lessees can elect to apply a method similar to Ind AS 17 (i.e., operating lease accounting) to leases of low-value assets. Examples of such assets include tablets and personal computers, small items of office furniture and telephones. This option is available on a **<u>'lease-by lease'</u>** basis.
4	Lease Classification	Lessees apply a **<u>dual</u>** recognition and measurement approach for all leases. Lessees classify a lease as a 'finance lease' if it transfers substantially all the risks and rewards incidental to ownership. Otherwise a lease is classified as an 'operating lease'.	Lessees apply a **<u>single</u>** recognition and measurement approach for all leases, with options not to recognize ROU assets and lease liabilities for short-term leases and leases of low-value assets. There is not more classification of leases into operating and finance in case of lessees.
5	Lease Payments	At the commencement of the lease term, lessees recognize finance leases as assets and liabilities in their balance sheet at amounts equal to: the fair value of the leased property ***OR*** the present value of the minimum lease payments, whichever is **<u>lower</u>**, each determined at the inception of the lease. Minimum lease payments are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the	At the commencement date, lessees measure the lease liability at the present value of the lease payments to be made over the lease term (except short-term leases and leases of low-value assets). Lease payments include: a) Fixed payments (including in-substance fixed payments), **<u>less</u>** any lease incentives receivable; b) Variable lease payments that depend on an index or a rate, initially measured using the index or rate at the commencement date; c) Amounts expected to be

		lessor, together with, for a lessee, any amounts guaranteed by the lessee or by a party related to the lessee. No assets and liabilities are recognized for the initial measurement of operating leases, i.e., operating leases only impacted the statement of profit or loss.	payable by the lessee under residual value guarantees; d) The exercise price of a purchase option if the lessee is reasonably certain to exercise that option; e) Payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease. In addition, the cost of the ROU asset comprises: a) The lease liability (as calculated above); b) Lease payments made at or before the commencement date, **less** any lease incentives received; c) Initial direct costs; d) Asset retirement obligations (unless those costs are incurred to produce inventories).
6	Reassessment of lease liability	Does not apply under Ind AS 17	After the commencement date, lessees are required to remeasure the lease liability when there is a lease modification (i.e., a change in the scope of a lease, ***OR*** the consideration for a lease that was not a part of the original terms and conditions of the lease) that is **NOT** accounted for as a separate contract. Lessees are also required to remeasure lease payments upon a change in **ANY** of the following: - The lease term; - The assessment of whether the lessee is reasonably certain to

			exercise an option to purchase the underlying asset; - The amounts expected to be payable under residual value guarantees; - Future lease payments resulting from a change in an index or rate.
7	Lease income from operating leases	Ind AS 17 contains a **<u>carve out</u>** of not straight-lining the lease escalation, if they are in line with the expected general inflation compensating the lessor for expected inflationary cost.	There is **<u>no such carve out</u>** under Ind AS 116 and thus, a lessor shall recognize lease payments from operating leases as income on either a straight-line basis or another systematic basis.
8	Lease modifications to an operating lease	Ind AS 17 doesn't mention about this.	Lessors account for a modification to an operating lease as a **<u>new lease</u>** from the effective date of the modification (considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease).
9	Lease modifications which do not result in new separate leases	Ind AS 17 doesn't mention about this.	**<u>Lessees:</u>** a) Allocate the consideration in the modified contract; b) Determine the lease term of the modified lease; c) Remeasure the lease liability by discounting the revised lease payments using a revised discount rate with a corresponding adjustment to ROU asset. Additionally, lessees recognize in profit or loss any gain or loss relating to the partial or full termination of the lease.

			Lessors: If a lease would have been an operating lease, had the modification been in effect at the inception date, lessors in a finance lease would: (i) Account for the modification as a new lease; (ii) Measure the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the modification. Otherwise, the modification is accounted for in accordance with Ind AS 109 *Financial Instruments*.
10	Presentation (Lessees) – Balance Sheet	Ind AS 17 doesn't mention about this.	**ROU Assets:** They are presented either: - Separately from other assets (e.g., owned assets) ***OR*** - Together with other assets as if they were owned, with disclosures of the balance sheet line items that include ROU Assets and their amounts ROU Assets that meet the definition of investment property are presented as investment property **Lease Liabilities:** They are presented either: - Separately from other liabilities ***OR*** - Together with other liabilities with disclosure of the balance sheet line items that include lease liabilities and their amounts
11	Presentation (Lessees) –	Operating lease expense is presented as a **single item**.	**Depreciation and Interest:**

	Statement of profit or loss		Lease-related depreciation and lease-related interest expense are presented **separately** (i.e., they **CANNOT** be combined). This is because interest expense on the lease liability is a component of finance costs, which paragraph 82(b) of Ind AS 1 *Presentation of Financial Statements* requires to be presented separately in the statement of profit or loss.
12	Presentation (Lessees) – Cashflow statement	**For operating leases:** Cash payments are included within **operating activities**.	**Principal portion of the lease liability:** - These cash payments are presented within financing activities **Interest portion of the lease liability:** - These cash payments are presented within financing activities **Short-term leases and leases of low-value assets:** - Lease payments pertaining to them (i.e., not recognised on the balance sheet as per Ind AS 116) are presented within operating activities **Variable lease payments not included in the lease liability:** - These are also presented within operating activities **Non-cash activity:** Such activity is disclosed as a supplemental non-cash item (e.g., the initial recognition of the lease at commencement)
13	Disclosures	Quantitative and qualitative disclosures are required but, generally **fewer** disclosures are required than those under Ind AS 116.	**Detailed** disclosures (including the format of disclosure) are required under Ind AS 116. **Additionally**, qualitative and quantitative information about

			leasing activities is required in order to meet the disclosure objective.
14	Sale and leaseback transactions – 'Sale'	Ind AS 17 focuses on whether the leaseback is an **operating or finance** lease.	Seller-lessees and buyer-lessors apply the requirements in Ind AS 115 to determine whether a **sale** has occurred in a sale and leaseback transaction.
15	Sale and leaseback transactions – Accounting by seller-lessees	If a sale and leaseback transaction results in a **finance lease**, any excess of sales proceeds over the carrying amount are deferred and amortized over the lease term. If a sale and leaseback transaction results in an **operating lease**, and it is clear that the transaction is established at fair value, any profit or loss is recognized immediately.	The seller-lessee measures the **ROU asset** arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right-of use retained by the seller-lessee and recognizes only the amount of any gain or loss that relates to the rights transferred to the buyer lessor.
16	Sale and leaseback transactions – Transactions NOT at fair value	If a sale and leaseback transaction results in an **operating lease** and the sale price is: - Below fair value: Any profit or loss is recognized immediately except that, if the loss is compensated for by future lease payments at below market price, it is deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. - Above fair value: The excess over fair value is deferred and amortised over the period for which the asset is expected to be used.	If the fair value of the consideration for the sale of an asset does **NOT**: equal the fair value of the asset ***OR*** if the payments for the lease are not at market rates then, an entity is required to measure the sale proceeds at fair value with an adjustment (as appropriate) either as a prepayment of lease payments (any **below** market terms) ***OR*** additional financing (any **above** market terms).
17	Business combinations	Unlike Ind AS 116, there is no exemption under Ind AS 17 for	The acquirer is not required to recognize ROU assets and

	– Acquiree is a lessee	leases with a remaining lease term of less than 12 months from the acquisition date, or leases for which the underlying asset is of low value (i.e., recognition exemptions). An intangible asset is recognized if the terms of operating lease are favourable relative to market terms and a liability is recognized if terms are unfavourable relative to market terms. An intangible asset may be associated with an operating lease, which may be evidenced by market participants' willingness to pay a price for the lease even if it is at market terms.	lease liabilities for leases with a remaining lease term of less than 12 months from the acquisition date, or leases for which the underlying asset is of a lower value (i.e., recognition exemptions). The acquirer measures the ROU asset at the same amount as the lease liability, adjusted to reflect favourable or unfavourable terms of the lease, relative to market terms.

3.9 KEY DIFFERENCES BETWEEN IND AS 116 AND AS 19

The significant differences between Ind AS 116 and AS 19 are given below:

Sr. No.	Particulars	Ind AS 116	AS 19
1	Lease definition	Under Ind AS 116, the definition of lease is similar to that in AS 19. But, in Ind AS 116, there is substantial change in the guidance of how to apply this definition. The changes primarily relate to the concept of 'control' used in identifying whether a contract contains a lease or not.	Under Ind AS 116, the definition of lease is similar to that in AS 19. However, guidance part given therein is different.
2	Modifications:	Ind AS 116 brings in comprehensive prescription on accounting of modifications in lease contracts.	No such comprehensive coverage is there

3	Scope	Ind AS 116 has no such scope exclusion	AS 19 excludes leases of land from its scope
		Ind AS 116 makes a distinction between 'inception of lease' and 'commencement of lease'	No such distinction has been made in AS 19
4	Classification	Ind AS 116 eliminates the requirement of classification of leases as either operating leases or finance leases for a lessee and instead, introduces a single lessee accounting model which requires lessee to recognise assets and liabilities for all leases unless it applies the recognition exemption applies.	AS 19 requires a lessee to classify leases as either finance leases or operating leases
5	Sale & Leaseback transactions	In Ind AS 116, the approach for computation of gain/loss for a completed sale is different. The amount of gain/loss should reflect the amount that relates to the right transferred to the buyer-lessor.	As per AS 19, if a sale and leaseback transaction results in a finance lease, excess, if any, of the sale proceeds over the carrying amount shall be deferred and amortised by the seller-lessee over the lease term in proportion to depreciation of the leased asset.
		Ind AS 116 requires a seller-lessee and a buyer-lessor to use the definition of a sale as per Ind AS 115, Revenue from Contracts with Customers to determine whether a sale has occurred in a sale and leaseback transaction. If the transfer of the underlying asset satisfies the requirements of Ind AS 115 to be accounted for as a sale, the transaction will be accounted for as a sale and a lease by both the lessee and the lessor. If not, then the seller-lessee shall recognise a finance liability and the buyer-lessor will	AS 19 does not contain such specific requirement

		recognise a financial asset to be accounted for as per the requirements of Ind AS 109, Financial Instruments.	
6	Treatment of initial direct costs		
	Finance lease – lessor accounting		
	Non-manufacturer/ Non-dealer	Either recognised as expense immediately or allocated against the finance income over the lease term.	Interest rate implicit in the lease is defined in such a way that the initial direct costs included automatically in the finance lease receivable.
	Manufacturer/dealer	Recognised as expense immediately.	Same as per AS 19.
	Operating lease- Lessor accounting	Either deferred and allocated to income over the lease term in proportion to the recognition of rent income, or recognized as expense in the period in which incurred	Added to the carrying amount of the leased asset and recognised as expense over the lease term on the same basis as lease income.
7	Initial direct costs	Ind AS 116 contains clearer definition of 'initial direct costs' Further, definition of the term 'interest rate implicit in the lease' has been modified in Ind AS 116.	Different guidance given
8	Presentation	As a consequence of introduction of single lease model for lessees, there are many changes in the presentation in the three components of financial statements viz. Balance sheet, Statement of P&L, Statement of Cash flows.	Different guidance given
9	Disclosure	There are a number of changes in the disclosure relating to qualitative aspects of leasing transactions. For eg. Entities are required to disclose the nature	Different guidance given

		and risks arising from leasing transactions. Also, in case of lessor, there are changes in the disclosure of maturity analysis of leases payments receivable.	

3.10 MAJOR CHANGES UNDER IND AS 116 FROM IFRS 16

Ind AS 116, like other Ind ASs, has been converged from the global standards, i.e., IFRSs, which has been made applicable to the Indian entities (based on the net worth criteria) in a phased manner via Ministry of Corporate Affairs Roadmap. While converging from IFRS 16 (which is applicable globally from the reporting periods beginning on or after 01 January 2019), following are the carve outs given under Appendix 1 to Ind AS 116, keeping in mind, the requirements of other converged Ind ASs and the economic environment in India:

Sr. No.	***Particulars***	***IFRS 16***	***Ind AS 116***
1	Subsequent measurement of investment property	Paragraph 34 of IFRS 16 provides that if lessee applies fair value model in IAS 40 to its investment property, it shall apply that fair value model to the ROU assets that meet the definition of investment property.	Paragraph 34 has been **deleted** under Ind AS 116 since Ind AS 40 *Investment Property* does **NOT** allow the use of fair value model. Consequently, reference of the same appearing anywhere under Ind AS 116 has also been **deleted**.
2	Interest portion of lease liability – classification in cash flow statement	Paragraph 50(b) of IFRS 16 requires to classify cash payments for interest portion of lease liability applying requirements of IAS 7 *Statement of Cash Flows*. IAS 7 provides option of treating interest paid as **operating or financing activity**.	Ind AS 7 requires interest paid to be treated as **financing activity only**. Accordingly, paragraph 50(b) has been **modified** under Ind AS 116 to specify that cash payments for interest portion of lease liability will be classified as financing activities applying Ind AS 7.

TEST YOUR KNOWLEDGE

QUESTIONS

1. A lessee enters into a ten-year contract with a lessor (freight carrier) to transport a specified quantity of goods. Lessor uses rail wagons of a particular specification, and has a large pool of similar rail wagons that can be used to fulfil the requirements of the contract. The rail wagons and engines are stored at lessor's premises when they are not being used to transport goods. Costs associated with substituting the rail wagons are minimal for lessor.

   Whether the lessor has substantive substitutions rights and whether the arrangement contains a lease?

2. Customer M enters into a 20-year contract with Energy Supplier S to install, operate and maintain a solar plant for M's energy supply. M designed the solar plant before it was constructed – M hired experts in solar energy to assist in determining the location of the plant and the engineering of the equipment to be used. M has the exclusive right to receive and the obligation to take any energy produced. Whether it can be established that M is having the right to control the use of identified asset?

3. A Customer enters into a ten-year contract with a Company (a ship owner) for the use of an identified ship. Customer decides whether and what cargo will be transported, and when and to which ports the ship will sail throughout the period of use, subject to restrictions specified in the contract. These restrictions prevent the company from sailing the ship into waters at a high risk of piracy or carrying explosive materials. The company operates and maintains the ship, and is responsible for safe passage.

   Does the customer has the right to direct how and for what purpose the ship is to be used throughout the period of use and whether the arrangement contains a lease?

4. A Lessee enters into a ten-year lease contract with a Lessor to use an equipment. The contract includes maintenance services (as provided by lessor). The Lessor obtains its own insurance for the equipment. Annual payments are ₹ 10,000 (₹ 1,000 relate to maintenance services and ₹ 500 to insurance costs).

   The Lessee is able to determine that similar maintenance services and insurance costs are offered by third parties for ₹ 2,000 and ₹ 500 a year, respectively. The Lessee is unable to find an observable stand-alone rental amount for a similar equipment because none is leased without related maintenance services provided by the lessor.

   How would the Lessee allocate the consideration to the lease component?

5. A Lessee enters into a non-cancellable lease contract with a Lessor to lease a building. Initially, the lease is for five years, and the lessee has the option to extend the lease by another five years at the same rental.

To determine the lease term, the lessee considers the following factors:

- Market rentals for a comparable building in the same area are expected to increase by 10% over the ten-year period covered by the lease. At inception of the lease, lease rentals are in accordance with current market rents.
- The lessee intends to stay in business in the same area for at least 20 years.
- The location of the building is ideal for relationships with suppliers and customers.

What should be the lease term for lease accounting under Ind AS 116?

6. A Lessee enters into a lease of a five-year-old machine. The non-cancellable lease term is 15 years. The lessee has the option to extend the lease after the initial 15-year period for optional periods of 12 months each at market rents.

   To determine the lease term, the lessee considers the following factors:

   - The machine is to be used in manufacturing parts for a type of plane that the lessee expects will remain popular with customers until development and testing of an improved model are completed in approximately 15 years.
   - The cost to install the machine in lessee's manufacturing facility is significant.
   - The non-cancellable term of lessee's manufacturing facility lease ends in 19 years, and the lessee has an option to renew that lease for another twelve years.
   - Lessee does not expect to be able to use the machine in its manufacturing process for other types of planes without significant modifications.
   - The total remaining life of the machine is 30 years.

   What should be the lease term for lease accounting under Ind AS 116?

7. A Company leases a manufacturing facility. The lease payments depend on the number of operating hours of the manufacturing facility, i.e., the lessee has to pay ₹ 2,000 per hour of use. The annual minimum payment is ₹ 2,00,00,000. The expected usage per year is 20,000 hours.

   Whether the said payments be included in the calculation of lease liability under Ind AS 116?

ANSWERS

1. In this case, the rail wagons are stored at lessor's premises and it has a large pool of similar rail wagons and substitution costs to be incurred are minimal. Thus, the lessor has the practical ability to substitute the asset. If at any point, the same become economically beneficial for the lessor to substitute the wagons, he can do so and hence, the lessor's substitution rights are substantive and the arrangement does not contain a lease.

2. In this case, the nature of the solar plant is such that all of the decisions about how and for what purpose the asset is used are predetermined because:

– the type of output (i.e. energy) and the production location are predetermined in the agreement; and

– when, whether and how much energy is produced is influenced by the sunlight and the design of the solar plant.

Because M designed the solar plant and thereby predetermined any decisions about how and for what purpose it is used, M is considered to have the right to direct the use. Although regular maintenance of the solar plant may increase the efficiency of the solar panels, it does not give the supplier the right to direct how and for what purpose the solar plant is used. Hence, M is having a right to control the use of asset.

3. The customer has the right to direct the use of the ship because the contractual restrictions are merely protective rights that protect the company's investment in the ship and its personnel. In the scope of its right of use, the customer determines how and for what purpose the ship is used throughout the ten-year period because it decides whether, where and when the ship sails, as well as the cargo that it will transport.

   The customer has the right to change these decisions throughout the period of use and hence, the contract contains a lease.

4. The observable stand-alone price for maintenance services is ₹ 2,000. There is no observable stand-alone price for the lease. Further, the insurance cost does not transfer a good or service to the lessee and therefore, it is not a separate lease component.

   Thus, the Lessee allocates ₹ 8,000 (₹ 10,000 – ₹ 2,000) to the lease component.

5. After considering all the stated factors, the lessee concludes that it has a significant economic incentive to extend the lease.

   Thus, for the purpose of lease accounting under Ind AS 116, the lessee uses a lease term of ten years.

6. The lessee notes that the terms for the optional renewal provide no economic incentive and the cost to install is significant. The lessee has no incentive to make significant modifications to the machine after the initial 15-year period. Therefore, the lessee does not expect to have a business purpose for using the machine after the non-cancellable lease term of 15 years.

   Thus, the lessee concludes that the lease term consists of the 15-year non-cancellable period only.

7. The said lease contains in-substance fixed payments of ₹ 2,00,00,000 per year, which are included in the initial measurement of the lease liability under Ind AS 116.

   However, the additional ₹ 2,00,00,000 that the company expects to pay per year are variable payments that do not depend on an index or rate and, thus, are not included in the initial measurement of the lease liability but, are expensed when the over-use occurs.

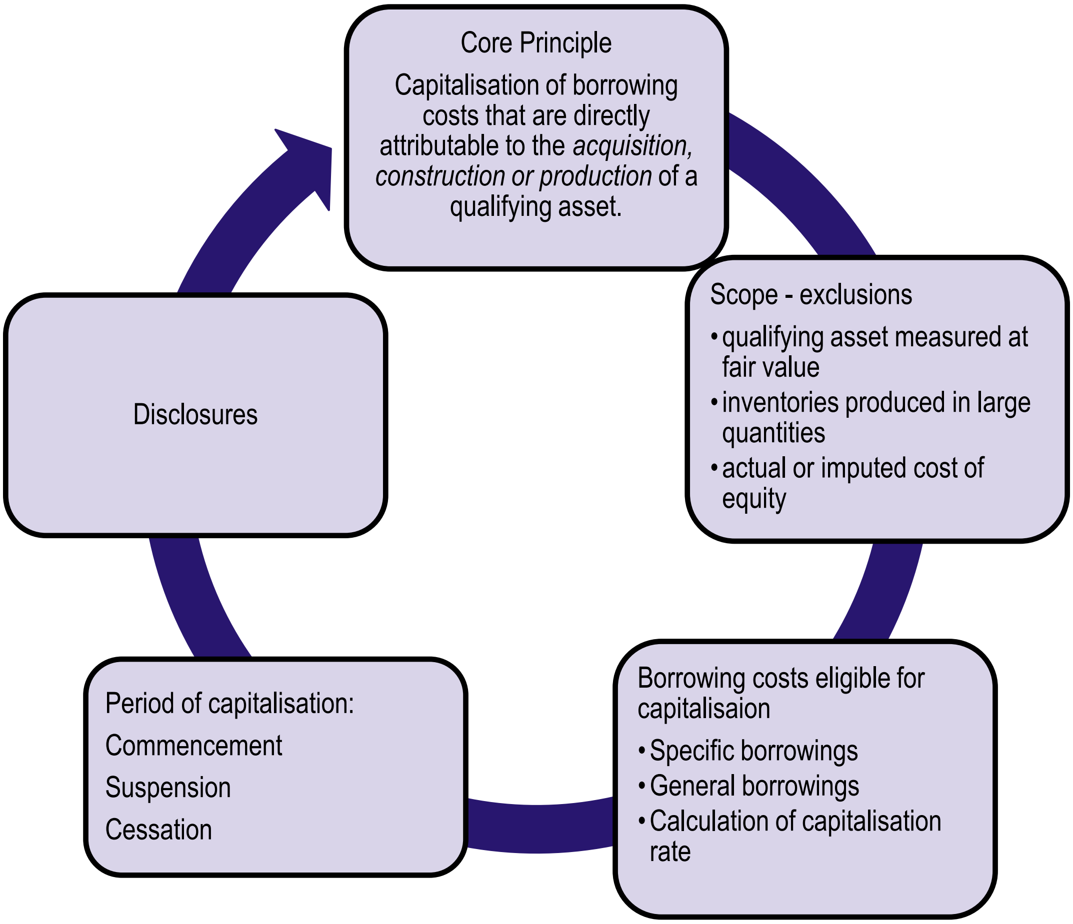
UNIT 4 : INDIAN ACCOUNTING STANDARD 23 : BORROWING COSTS

LEARNING OUTCOMES

After studying this unit, you will be able to:

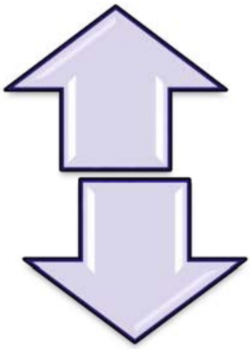
- Appreciate the core principle and scope of this standard
- Define borrowing cost, qualifying asset and other related terms
- Recognise various conditions and pre-conditions for capitalisation of borrowing costs
- Evaluate suspension and cessation of capitalization of such borrowing cost
- Comply with the disclosure requirements of the standard
- Differentiate between Ind AS 23 and AS 16.

UNIT OVERVIEW



4.1 CORE PRINCIPLE

This standard requires borrowing costs that are directly attributable to the *acquisition, construction or production* of a qualifying asset are included in the cost of that asset. Other borrowing costs are recognised as an expense.



"Borrowing costs' that are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset.

Other borrowing costs are recognised as an expense.

4.2 SCOPE

- An entity shall apply this standard in accounting for borrowing costs.
- The Standard does not apply to actual or imputed cost of equity, including preferred capital not classified as a liability.

  For example: Dividend paid on equity shares, cost of issuance of equity, cost on Irredeemable preference share capital will not be included as borrowing cost within the purview of this standard.

- An entity is not required to apply the Standard to borrowing costs directly attributable to the acquisition, construction or production of:

  (a) a qualifying asset measured at fair value, for example, a biological asset accounted for under Ind AS 41; or

  (b) inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis. and that take a substantial period to get ready for sale. For example, whisky, wines etc. takes substantial period of time, may be years to get ready for the intended purpose are out of scope from the purview of this standard.

4.3 RELEVANT DEFINITIONS

- Borrowing Cost and Qualifying asset are the two key pillars of this standard. In reference to this standard, borrowing cost states what needs to be capitalised and qualifying asset states on which asset these cost should be capitalised.

  Let us see the definitions and inclusion of these two key words.

  1. **Borrowing costs** are interest and other costs that an entity incurs in connection with the borrowing of funds.

2. A **qualifying asset** is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

- Borrowing costs may include:

  (a) interest expense calculated using the effective interest method as described in Ind AS 109 *Financial Instruments*;

  (b) interest in respect of lease liabilities recognised in accordance with Ind AS 116, Leases; and

  (c) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

4.3.1 Exchange difference to be included in borrowing costs

- With regard to exchange difference required to be treated as borrowing costs, the manner of arriving at the adjustments stated therein should be as follows:

  (i) the adjustment should be of an amount which is equivalent to the extent to which the exchange loss does not exceed the difference between the cost of borrowing in functional currency when compared to the cost of borrowing in a foreign currency.

Example :

An entity can borrow funds in its functional currency (₹) @ 12%. It borrows \$ 1,000 @ 4% on 1st April, 20X1 when \$ 1 = ₹ 40. The equivalent amount in functional currency is ₹ 40,000. Interest is payable on 31st March, 20X2. On 31st March, 20X2, exchange rate is \$ 1 = ₹ 50. The loan is not due for repayment. The exchange loss in this case is ₹ 10,000 [\$ 1000 x (₹ 50- ₹ 40)]. The borrowing cost is ₹ 2,000 (\$ 1,000 x 4% x ₹ 50). Had the entity borrowed in functional currency the borrowing cost would have been ₹ 4,800 (₹ 40,000 x 12%). The entity will treat exchange difference upto ₹ 2,800 (₹ 4,800 – ₹ 2,000) as a borrowing cost that may be eligible for capitalisation under this Standard. Thus the total eligible borrowing cost is ₹ 4,800 (₹ 2,000 + ₹ 2,800) equivalent to the cost of borrowing cost in functional currency.

If the exchange rate on 31st March, 20X2, is \$ 1 = ₹ 41. The exchange loss is ₹ 1,000 [\$ 1,000 – (₹ 41 – ₹ 40)]. The entity will treat the entire exchange loss as an eligible borrowing cost as total cost of the borrowing ₹ 2,640 [(₹ 1,000 x 4% x 41) + ₹ 1,000] in foreign currency does not exceed the cost of borrowings in functional currency, i.e., ₹ 4,800.

  (ii) where there is an unrealised exchange loss which is treated as an adjustment to interest and subsequently there is a realised or unrealised gain in respect of the settlement or translation of the same borrowing, the gain to the extent of the loss previously recognised as an adjustment should also be recognised as an adjustment to interest.

Example : Continuing with the aforesaid example:

If the exchange rate on 31st March, 20X3, is $ 1 = ₹ 48; the exchange rate on 31st March, 20X2, being $ 1= ₹ 50, the borrowings are still not due for payment. The entity will recognise a borrowing cost of ₹ 1,920 ($ 1,000 x 4% x ₹ 48). There is an exchange gain of ₹ 2,000 ($ 1,000 x (₹ 50 – ₹48). This will be adjusted in the borrowing cost as there is unrealised exchange loss and the adjustment is less than the exchange loss of ₹ 2,800 recognised in earlier year.

If the exchange rate on 31st March, 20X3, is $ 1 = ₹ 44; the exchange rate on 31st March, 20X2, being $ 1 = ₹ 50, the borrowings are still not due for payment. The entity will recognise a borrowing cost of ₹ 1,760 ($ 1,000 x 4% x ₹ 44). There is an exchange gain of ₹ 6,000 [$ 1,000 x (₹ 50 – ₹ 44)]. This will be adjusted in the borrowing cost upto ₹ 2,800 as there is unrealised exchange loss and the adjustment of the exchange loss recognised in earlier years is of ₹ 2,800.

If the exchange rate on 31st March, 20X3, is $ 1 = ₹ 44 and part of loan is repaid; the exchange rate on 31st March, 20X2, being $ 1 = ₹ 50; $ 600 of the borrowings was paid on 31st March, 20X2, $ 400 of the borrowings are still not due for payment. The entity will recognise a borrowing cost of ₹ 704 ($ 400 x 4% x ₹ 44). There is an exchange gain of ₹ 2400 [$ 400 x (₹ 50 – ₹ 44)]. The unrealised exchange loss of earlier year is ₹ 4,000 [$ 400 x (₹ 50 – ₹ 40)] out of which ₹ 1,120 (₹ 2,800 x $ 400 / $ 1000) was charged in 31st March, 20X1, as borrowing cost. Thus there will be an adjustment in the borrowing cost upto ₹ 1,120 as this is unrealised exchange loss.

Illustration 1

ABC Ltd. has taken a loan of USD 20,000 on 1st April, 20X1 for constructing a plant at an interest rate of 5% per annum payable on annual basis.

On 1st April, 20X1, the exchange rate between the currencies i.e USD vs Rupees was ₹ 45 per USD. The exchange rate on the reporting date i.e 31st March, 20X2 is ₹ 48 per USD.

The corresponding amount could have been borrowed by ABC Ltd from State bank of India in local currency at an interest rate of 11% per annum as on 1st April, 20X1.

Compute the borrowing cost to be capitalized for the construction of plant by ABC Ltd.

Solution

In the above situation, the Borrowing cost needs to determine for interest cost on such foreign currency loan and eligible exchange loss difference if any.

(a) Interest on Foreign currency loan for the period:

USD 20,000 x 5% = USD 1,000

Converted in ₹: USD 1,000 x ₹ 48/USD = ₹ 48,000

Increase in liability due to change in exchange difference: USD 20,000 x (48 - 45) = ₹ 60,000

(b) Interest that would have resulted if the loan was taken in Indian Currency:

USD 20,000 x ₹ 45/USD x 11% = ₹ 99,000

(c) Difference between Interest on Foreign Currency borrowing and local Currency borrowing:

₹ 99,000 - 48,000 = ₹ 51,000

Hence, out of Exchange loss of ₹ 60,000 on principal amount of foreign currency loan, only exchange loss to the extent of ₹ 51,000 is considered as borrowing costs.

Total borrowing cost to be capitalized is as under :

(a)	Interest cost on borrowing	₹ 48,000
(b)	Exchange difference to the extent considered to be an adjustment to Interest cost	₹ 51,000
		₹ 99,000

The exchange difference of ₹ 51,000 has been capitalized as borrowing cost and the remaining ₹ 9,000 will be expensed off in the Statement of Profit and loss.

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4.3.2 Key Note on Qualifying Assets

Depending on the circumstances, any of the following may be qualifying assets:

(a) inventories

(b) manufacturing plants

(c) power generation facilities

(d) intangible assets

(e) investment properties

(f) bearer plants.

- Financial assets and inventories that are manufactured, or otherwise produced, over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired are not qualifying assets.

4.4 RECOGNITION

- Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are capitalised as part of the cost of the qualifying asset. Such borrowing cost are capitalised when below two conditions will be satisfied:
  - when it is probable it will result in future economic benefits to the entity; and
  - the costs can be measured reliably.
- Other borrowing costs are recognisied as an expense in the period in which they are incurred.
- When an entity applies Ind AS 29 *Financial Reporting in Hyperinflationary Economies*, it recognises as an expense the part of borrowing costs that compensates for inflation during the same period.

4.4.1 Borrowing costs eligible for capitalisation

The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made.

4.4.1.1 Specific borrowing costs

- When an entity borrows funds specifically for the purpose of obtaining a qualifying asset, the entity should determine the amount of borrowing costs eligible for capitalisation as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.
- The financing arrangements for a qualifying asset may result in an entity obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditures on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any investment income earned on such funds is deducted from the borrowing costs incurred.

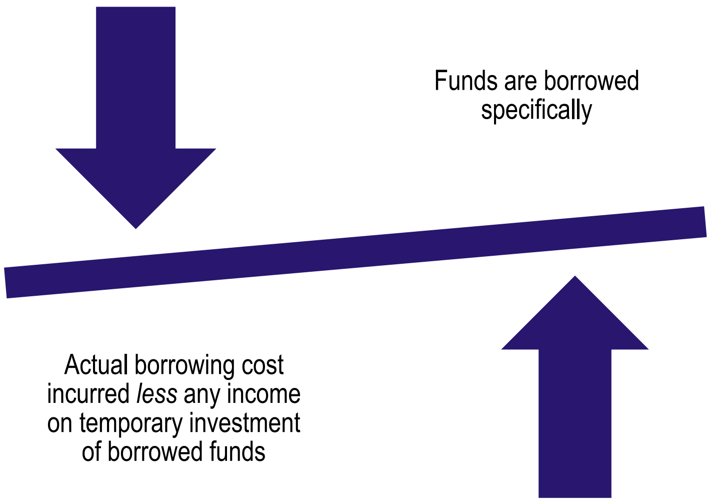

Illustration 2

Alpha Ltd. on 1st April, 20X1 borrowed 9% ₹30,00,000 to finance the construction of two qualifying assets. Construction started on 1st April, 20X1. The loan facility was availed on 1st April, 20X1 and was utilized as follows with remaining funds invested temporarily at 7%.

	Factory Building	Office Building
1st April, 20X1	5,00,000	10,00,000
1st October, 20X1	5,00,000	10,00,000

Calculate the cost of the asset and the borrowing cost to be capitalized.

Solution:

Particulars	Factory Building	Office Building
Borrowing Costs	(10,00,000 x 9%) 90,000	(20,00,000 x 9%) 1,80,000
Less: Investment Income	(5,00,000 x 7% x 6/12) (17,500)	(10,00,000 x 7% x 6/12) (35,000)
	72,500	1,45,000
Cost of the asset:		
Expenditure incurred	10,00,000	20,00,000
Borrowing Costs	72,500	1,45,000
Total	**10,72,500**	**21,45,000**

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4.4.1.2 General borrowing costs

- When a qualifying asset is funded from a pool of general borrowings, the amount of the borrowing costs eligible for capitalisation is not so obvious. It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided.
- Such a difficulty occurs, for example, when the financing activity of an entity is coordinated centrally. Difficulties also arise when a group uses a range of debt instruments to borrow funds at varying rates of interest, and lends those funds on various bases to other entities in the group.

4.4.2 Calculation of capitalisation rate

- To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset.
- The capitalisation rate is the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period.
- ***The capitalisation rate shall be the weighted average of the borrowing costs applicable to all borrowings of the entity that are outstanding during the period. However, an entity shall exclude from this calculation borrowing costs applicable to borrowings made specifically for the purpose of obtaining a qualifying asset until substantially all the activities necessary to prepare that asset for its intended use or sale are complete.***
- The amount of borrowing costs that an entity capitalises during a period shall not exceed the amount of borrowing costs it incurred during that period.

Total general borrowing costs for the period (excluding specific borrowings) ÷ Weighted average total general borrowings (excluding specific borrowings) = Capitalisation rate

Illustration 3

Beta Ltd had the following loans in place at the end of 31st March, 20X2:

(Amounts in ₹ 000s)

Loan	***1st April, 20X1***	***31st March, 20X2***
18% Bank Loan	*1,000*	*1,000*
16% Term Loan	*3,000*	*3,000*
14% Debentures	*-*	*2,000*

14% debenture was issued to fund the construction of Office building on 1st July, 20X1 but the development activities has yet to be started.

On 1st April, 20X1, Beta ltd began the construction of a Plant being qualifying asset using the existing borrowings. Expenditure drawn down for the construction was: ₹ 500,000 on 1st April, 20X1 and ₹ 2,500,000 on 1st January, 20X2.

Calculate the borrowing cost that can be capitalised for the plant.

Solution

Capitalisation rate	$\frac{(18\% \text{ x } 1{,}000)}{1{,}000+3{,}000}+\frac{(16\% \text{ x } 3{,}000)}{1{,}000+3{,}000}$	16.5%
Borrowing Costs	(500,000 x 16.5%)+(2,500,000 x16.5% x 3/12)	₹ 1,85,625

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4.4.3 Expenditure to which capitalisation rate is applied

- In calculation of borrowing costs to be capitalised, the amount of expenditure on a qualifying asset include only those expenditures that have resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities.
- Expenditures are reduced by any progress payments received and grants received in connection with the asset (see Ind AS 20 *Accounting for Government Grants and Disclosure of Government Assistance*).
- The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditures to which the capitalisation rate is applied in that period.

4.4.4 Excess of the carrying amount over recoverable amount

When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realisable value, the carrying amount is written down or written off in accordance with the requirements of other Standards. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other Standards.

4.5 PERIOD OF CAPITALISATION

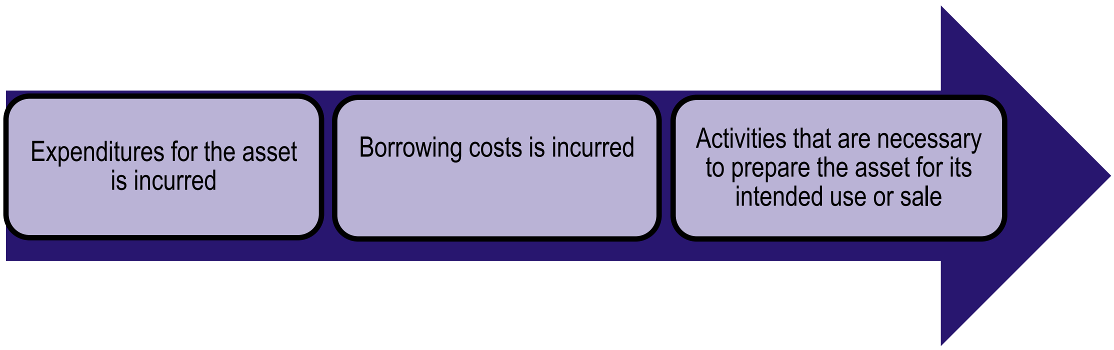
4.5.1 Commencement of capitalisation

- An entity is required to begin the capitalizing of borrowing costs as part of the cost of a qualifying asset on the commencement date. The commencement date for capitalisation is the date when the entity first meets all of the following conditions cumulatively on a particular date:

  (a) it incurs expenditures for the asset;

  (b) it incurs borrowing costs; and

  (c) it undertakes activities that are necessary to prepare the asset for its intended use or sale.



Explanation to the three conditions for commencement date

- Expenditures on a qualifying asset include:

  - Those expenditures that have resulted in payments of cash
  - transfers of other assets
  - assumption of interest bearing liabilities

  Expenditures are reduced by any progress payments received and grants received in connection with the asset.

- Activities necessary to prepare asset for its intended use or sale:

  - Includes technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the physical construction.
  - exclude the holding of an asset when no production or development that changes the asset's condition is taking place.

For example, borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation.

Illustration 4 : Commencement Date

X Ltd is commencing a new construction project, which is to be financed by borrowing. The key dates are as follows:

(i) 15th May, 20X1: Loan interest relating to the project starts to be incurred

(ii) 2nd June, 20X1 : Technical site planning commences

(iii) 19th June, 20X1 : Expenditure on the project started to be incurred

(iv) 18th July, 20X1 : Construction work commences

Identify commencement date.

Solution

In the above case, the three conditions to be tested for commencement date would be:

Borrowing cost has been incurred on : 15th May, 20X1

Expenditure has been incurred for the asset on : 19th June, 20X1

Activities necessary to prepare asset for its intended use or sale: 2nd June, 20X1

Commencement date would be the date when the above three conditions would be satisfied in all i.e 19th June, 20X1

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4.5.2 Suspension of capitalisation

- An entity is required to suspend the capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset. Such costs are costs of holding partially completed assets and do not qualify for capitalisation.
- An entity does not required to suspend capitalising borrowing costs when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalisation continues during the extended period that high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographical region involved.

Example: Suspension of Capitalisation

(a) Construction suspended between October, 20X1 to January, 20X2 during which period certain heavy construction equipment under use was shifted to another site.

In this case, capitalization of borrowing costs needs to be suspended since active development is interrupted.

(b) When Qualifying Asset construction is about to complete, there was temporary delay of 20 days on account of some technical reasons.

In this case, capitalization of borrowing costs shall be continued.

4.5.3 Cessation of capitalisation

- An entity should cease capitalising borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.
- An asset is normally ready for its intended use or sale when the physical construction of the asset is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the purchaser's or user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.
- When an entity completes the construction of a qualifying asset in parts and each part is capable of being used while construction continues on other parts, the entity shall cease capitalising borrowing costs when it completes substantially all the activities necessary to prepare that part for its intended use or sale.
- A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being usable while construction continues on other parts.

  An example of a qualifying asset that needs to be complete before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill.

Example:

H Limited, a real estate company, gives immovable property on rent. It has completed on 31st May, 20X1, a commercial complex consisting of various offices that could be rented out. It expects that the commercial complex will be completely rented out by 30th June, 20X1. However, due to adverse market conditions, only 10% of the commercial complex could be rented out by its reporting date of 31st March, 20X2. H Limited wants to capitalise the eligible borrowing costs incurred up to 31st March, 20X2.

H Limited should capitalise borrowing costs only up to 31st May, 20X1. The borrowing cost incurred thereafter cannot be capitalised as the asset was ready for its intended use on 31st May, 20X1. The fact that only a small portion could be rented out by 31st March, 20X2, is immaterial.

Example:

An entertainment park consisting of several rides and facilities, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being usable while construction continues on other parts. On the other side in a case of an industrial undertaking such as a steel mill, all parts have to be completed before any earlier completed part can be put to use.

4.6 DISCLOSURE

Entities are required to disclose:

(a) the amount of borrowing costs capitalised during the period; and

(b) the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

4.7 SIGNIFICANT DIFFERENCES IN IND AS 23 *VIS-À-VIS* AS 16

S. No.	Particular	Ind AS 23	AS 16
1.	*Qualifying Asset measured at Fair Value*	Ind AS 23 does not require an entity to apply this standard to borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset measured at fair value, for example, a biological asset	AS 16 does not provide for such scope relaxation
2.	*Applicability to Inventories*	Ind AS 23 excludes the application of this Standard to borrowing costs directly attributable to the acquisition, construction or production of inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis	AS 16 does not provide for such scope relaxation and is applicable to borrowing costs related to all inventories that require substantial period of time to bring them in saleable condition
3.	*Inclusion as Borrowing Costs*	Ind AS 23 requires to calculate the interest expense using the effective interest rate method as	AS 16, *Borrowing Costs*, inter alia, include the following:

		described in Ind AS 109. Certain items therein have been deleted, as some of those components of borrowing costs are considered as the components of interest expense calculated using the effective interest rate method.	• interest and commitment charges on bank borrowings and other short-term and long-term borrowings; • amortisation of discounts or premiums relating to borrowings; • amortisation of ancillary costs incurred in connection with the arrangement of borrowings
4.	*Explanation of Substantial Period of Time*	This explanation is not included in Ind AS 23.	AS 16 gives explanation for meaning of 'substantial period of time' appearing in the definition of the term 'qualifying asset'.
5.	*Reporting in Hyperinflationary Economies*	Ind AS 23 provides that when Ind AS 29, '*Financial Reporting in Hyperinflationary Economies'*, is applied, part of the borrowing costs that compensates for inflation should be expensed as required by that Standard (and not capitalized in respect of qualifying assets).	AS 16 does not contain a similar clarification because at present, in India, there is no Standard on '*Financial Reporting in Hyperinflationary Economies'*.
6.	*Borrowings of the Parent and its Subsidiaries for Computing Weighted Average*	Ind AS 23 specifically provides that in some circumstances, it is appropriate to include all borrowings of the parent and its subsidiaries when computing a weighted average of the borrowing costs while in other circumstances, it is appropriate for each subsidiary to use a weighted average of the borrowing costs applicable to its own borrowings.	This specific provision is not there in AS 16.
7.	*Disclosure of Capitalisation Rate*	Ind AS 23 requires disclosure of capitalization rate used to determine the amount of borrowing costs eligible for capitalization.	AS 16 does not have this disclosure requirement.

TEST YOUR KNOWLEDGE

Questions

1. Marine Transport Limited ordered 3 ships for its fleet on 1st April, 20X0. It pays a down payment of 25% of the contract value of each of the ship out of long term borrowings from a scheduled bank. The delivery has to commence from the financial year 20X7. On 1st March, 20X2, the ship builder informs that it has commenced production of one ship. There is no progress on other 2 ships. Marine Transport Limited prepares its financial statements on financial year basis.

Is it permissible for Marine Transport Limited to capitalise any borrowing costs for the financial year ended 31st March, 20X1 or 31st March, 20X2.

2. X Limited has a treasury department that arranges funds for all the requirements of the Company including funds for working capital and expansion programs. During the year ended 31st March, 20X2, the Company commenced the construction of a qualifying asset and incurred the following expenses:

Date	Amount (₹)
1st July, 20X1	2,50,000
1st December, 20X1	3,00,000

The details of borrowings and interest thereon are as under:

Particulars	Average Balance (₹)	Interest (₹)
Long term loan @ 10%	10,00,000	1,00,000
Working capital loan	5,00,000	65,000
	15,00,000	1,65,000

Compute the borrowing costs that need to be capitalised.

Answers

1. As per paragraph 5 of Ind AS 23, a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

   As per paragraph 17 of Ind AS 23, an entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date. The commencement date for capitalisation is the date when the entity first meets all of the following conditions:

   (a) It incurs expenditures for the asset.

   (b) It incurs borrowing costs.

   (c) It undertakes activities that are necessary to prepare the asset for its intended use or sale.

The ship is a qualifying asset as it takes substantial period of time for its construction. Thus the related borrowing costs should be capitalised.

Marine Transport Limited borrows funds and incurs expenditures in the form of down payment on 1st April, 20X0. Thus condition (a) and (b) are met. However, condition (c) is met only on 1st March, 20X2, and that too only with respect to one ship. Thus there is no capitalisation of borrowing costs during the financial year ended 31st March, 20X1. Even during the financial year ended 31st March, 20X2, borrowing costs relating to the 'one' ship whose construction had commenced from 1st March, 20X2 will be capitalised from 1st March, 20X2 to 31st March, 20X2. All other borrowing costs are expensed.

2. The capitalisation rate is:

Total borrowing costs / Weighted average total borrowings: 1,65,000/15,00,000 = 11% Interest will be capitalised as under:

— On ₹ 2,50,000 @ 11% p.a. for 9 months = ₹ 20,625

— On ₹ 3,00,000 @ 11% p.a. for 4 months = ₹ 11,000

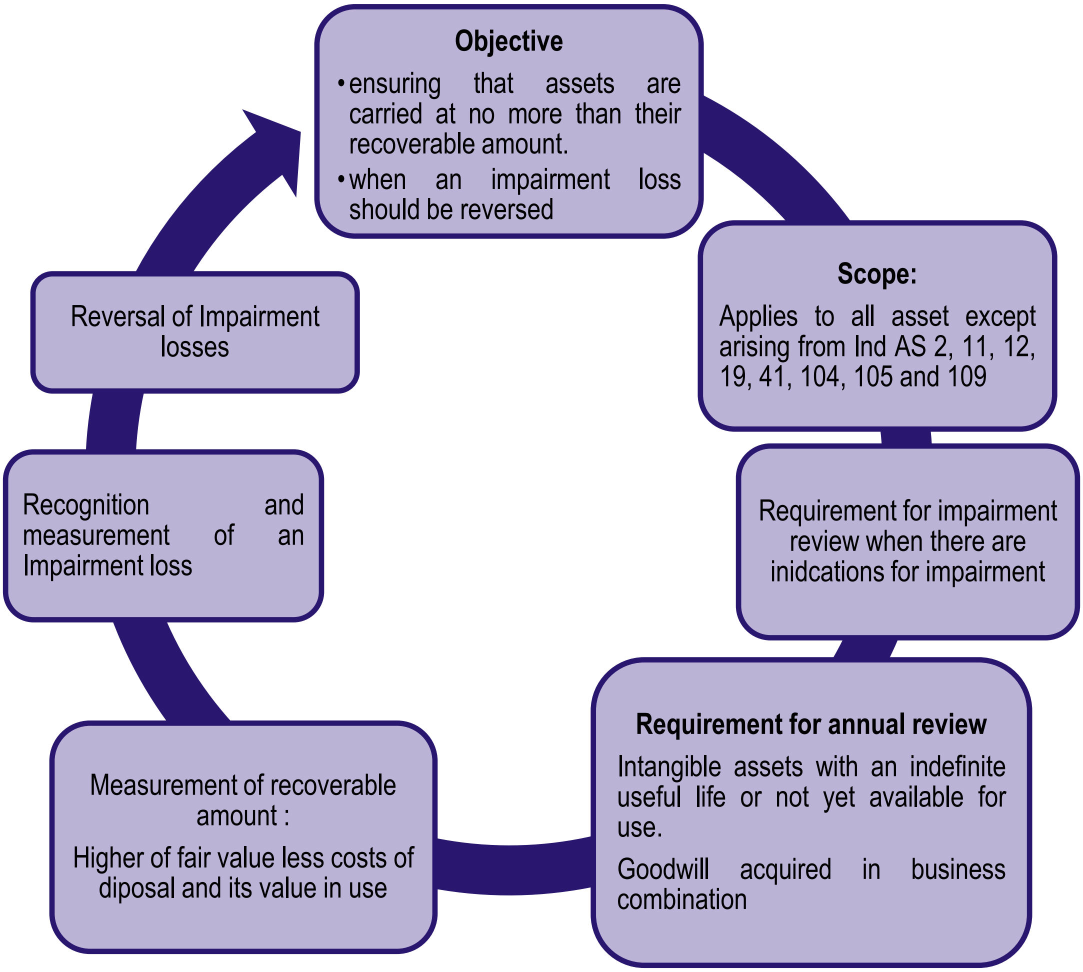
UNIT 5 : INDIAN ACCOUNTING STANDARD 36 : IMPAIRMENT OF ASSETS

LEARNING OUTCOMES

After studying this unit, you will be able to

- Comprehend the objective and scope of this standard
- Define the terms impairment loss, cash-generating unit, corporate assets, recoverable amount etc.
- Examine the criteria for identifying an asset that may be impaired
- Measure the Recoverable Amount
- Recognise and Measure the Impairment loss
- Identify and examine the Cash Generating Unit of the entity and impair the Goodwill
- Allocate and Reverse the Impairment loss
- Disclose the facts as per the requirement of the standard
- Differentiate between Ind AS 36 and AS 28.

UNIT OVERVIEW



5.1 OBJECTIVE

The objective of this Standard is to prescribes the methodology that an entity applies to ensure that its assets are not carried at more than their recoverable amount (i.e. the higher of fair value less costs of disposal and value in use). With the exception of goodwill and certain intangible assets for which an annual impairment test is required.

An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. In such case, the asset is described as impaired and the Standard requires the entity to recognise an impairment loss.

The Standard also specifies when an entity shall reverse an impairment loss and prescribes disclosures.

5.2 SCOPE

- This Standard shall be applied in accounting for the impairment of all assets, other than:

  - Inventories (as covered in Ind AS 2)
  - Contract assets and assets arising from costs to obtain or fulfill a contract (Ind AS 115)
  - Deferred tax assets (Ind AS 12)
  - Assets arising from employees benefits (Ind AS 19)
  - Biological Assets measured at fair value less cost to sell (Ind AS 41)
  - Deferred acquisition costs and intangible assets arising from insurance contracts (Ind AS 104)
  - Non-current assets (or disposal groups) classified as held for sale (as covered in Ind AS 105)
  - Financial Assets (within the scope of Ind AS 109)

- This Standard applies to financial assets classified as:

  - Subsidiaries, as defined in Ind AS 110, Consolidated Financial Statements
  - Associates, as defined in Ind AS 28 Investments in Associates and Joint Ventures
  - Joint ventures, as defined in Ind AS 111, Joint Arrangements

Impairment of other financial assets shall be accounted as per Ind AS 109, Financial Instruments.

5.3 RELEVANT DEFINITIONS

The following are the key terms used in this standard:

1. ***Carrying amount*** is the amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.

2. A ***cash-generating unit*** is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

3. ***Corporate assets*** are assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units.

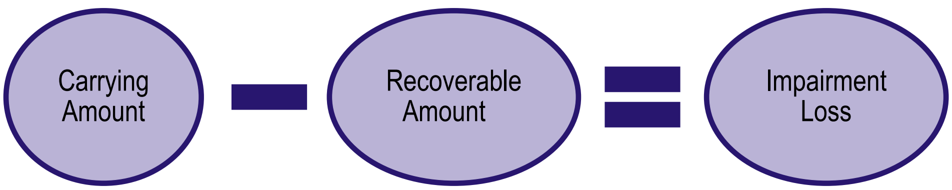
4. ***Costs of disposal*** are incremental costs directly attributable to the disposal of an asset or cash-generating unit, excluding finance costs and income tax expense.

5. ***Depreciable amount*** is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.

6. ***Depreciation (Amortisation)*** is the systematic allocation of the depreciable amount of an asset over its useful life.

7. ***Fair value*** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (refer Ind AS 113 Fair Value Measurement).

8. An ***impairment loss*** is the amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount.



9. The ***recoverable amount*** of an asset or a cash-generating unit is the higher of its fair value less costs of disposal and its value in use.

10. ***Useful life*** is either:

    a) the period of time over which an asset is expected to be used by the entity; or

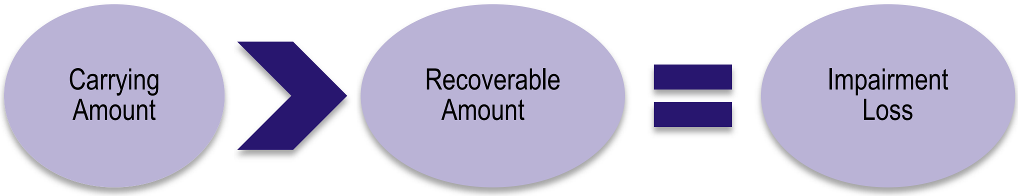
    b) the number of production or similar units expected to be obtained from the asset by the entity.

11. ***Value in use*** is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.

5.4 IDENTIFYING AN ASSET THAT MAY BE IMPAIRED

5.4.1 Identifying an asset that may be impaired - General

- An asset is impaired when its carrying amount exceeds its recoverable amount.



- An entity shall **assess** at the end of each reporting period whether there is any **indication** that an asset may be impaired. If any such indication exists, the entity is required to estimate the **recoverable amount** of the asset.
- Irrespective of whether there is any indication of impairment, an entity is required to test following items for impairment at least annually:

For above three assets, the entity should not have wait for Impairment indicators, rather there is mandate of impairment testing. We will discuss this aspect in detail in the next section.

5.4.2 Indications of impairment

In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:

5.4.2.1 External source of Information

The following are external source of information which may indicate that an asset is impaired:

a) during the period, an asset's **market value** has **declined significantly** more than would be expected as a result of the passage of time or normal use.;

b) significant changes with an **adverse effect** on the entity have taken place during the period, or will take place in the near future, in the **technological, market, economic or legal environment** in which the entity operates or in the market to which an asset is dedicated;

c) market **interest rates** or other market rates of return on investments have **increased** during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially; and

d) the carrying amount of the net assets of the entity is more than its market capitalisation.

5.4.2.2 Internal source of Information

The following are internal source of information which may indicate that an asset is impaired:

a) evidence is available of **obsolescence or physical damage** of an asset;

b) significant changes with an **adverse effect** on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, **an asset is used or is expected to be used**. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite;

c) evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected. Such evidence may include:

   (i) cash flows for acquiring the asset, or subsequent cash needs for operating or maintaining it, that are significantly higher than those originally budgeted;

   (ii) actual net cash flows or operating profit or loss flowing from the asset that are significantly worse than those budgeted;

   (iii) a significant decline in budgeted net cash flows or operating profit, or a significant increase in budgeted loss, flowing from the asset; or

   (iv) operating losses or net cash outflows for the asset, when current period amounts are aggregated with budgeted amounts for the future.

5.4.2.3 Dividend from a subsidiary, jointly controlled entity or associate

For an investment in a subsidiary, jointly controlled entity or associate, the investor recognises a dividend from the investment and evidence is available that:

(i) the carrying amount of the investment in the separate financial statements exceeds the carrying amounts in the consolidated financial statements of the investee's net assets, including associated goodwill; or

(ii) the dividend exceeds the total comprehensive income of the subsidiary, jointly controlled entity or associate in the period the dividend is declared.

The above list is not exhaustive. An entity may identify other indications that an asset may be impaired and these would also require the entity to determine the asset's recoverable amount or, in the case of goodwill, perform an impairment test.

If market interest rates or other market rates of return on investments have increased during the period, an entity is not required to make a formal estimate of an asset's recoverable amount in the following cases:

a) if the discount rate used in calculating the asset's value in use is unlikely to be affected by the increase in these market rates. For example, increases in short-term interest rates may not have a material effect on the discount rate used for an asset that has a long remaining useful life; or

b) if the discount rate used in calculating the asset's value in use is likely to be affected by the increase in these market rates but previous sensitivity analysis of recoverable amount shows that:

   (i) it is unlikely that there will be a material decrease in recoverable amount because future cash flows are also likely to increase (e.g. in some cases, an entity may be able to demonstrate that it adjusts its revenues to compensate for any increase in market rates); or

   (ii) the decrease in recoverable amount is unlikely to result in a material impairment loss.

External sources of information	Internal sources of information	Investment in a subsidiary, joint venture or associate
Significant decline in market value (more than normal decline)	Obsolescence or physical damage of an asset	Carrying amount of investment (in separate financial statements) > Carrying amounts of investee's net assets (including associated goodwill) in the consolidated financial statements
Significant changes in technology, market, economic or legal environment with adverse effect on entity	Significant changes in use or expected to be used of an asset with an adverse effect on entity	Dividend > Total Comprehensive income of investee
Increase in market interest rates or rate of returns	Internal reporting indicating worse economic performance of asset than expected	
Carrying amount of net assets of entity is more than its market capitalisation		

5.5 REQUIREMENT FOR ANNUAL REVIEW

5.5.1 Items required to be tested for impairment at least annually

Irrespective of whether there is any indication of impairment, an entity is required to test following items for impairment at least annually:

a) intangible asset with an indefinite useful life;

b) intangible asset not yet available for use; and

c) goodwill acquired in a business combination for impairment.

5.5.2 Intangible assets required to be tested for impairment at least annually

Intangible asset with an indefinite useful life and intangible assets not yet available for use to be tested for impairment

a) annually; and

b) and whenever there is an indication, at the end of a reporting period, that the asset may be impaired

by comparing its carrying amount with its recoverable amount, irrespective of whether there is any indication that it may be impaired.

- This impairment test may be performed at any time during an annual period, provided it is performed at the same time every year and whenever there is an indication, at the end of a reporting period, that the asset may be impaired.

For example:

Intellectual Property rights (IPR) having Indefinite useful life has been tested for Impairment in the first quarter of FY 20X1-20X2. Impairment testing on such assets needs to be mandatory done in the same time frame i.e first quarter of FY 20X2-20X3. Suppose, there is indication of impairment in third quarter of FY 20X2-20X3, in such case, the company needs to do impairment testing in third quarter apart from mandatory annual review.

- Different intangible assets may be tested for impairment at different times. However, if such an intangible asset was initially recognised during the current annual period, that intangible asset shall be tested for impairment before the end of the current annual period
- However, the most recent detailed calculation of such an asset's recoverable amount made in a preceding period may be used in the impairment test for that asset in the current period, provided all of the following criteria are met:

a) if the intangible asset does not generate cash inflows from continuing use that are largely independent of those from other assets or groups of assets and is therefore tested for impairment as part of the cash-generating unit to which it belongs, the assets and liabilities making up that unit have not changed significantly since the most recent recoverable amount calculation;

b) the most recent recoverable amount calculation resulted in an amount that exceeded the asset's carrying amount by a substantial margin; and

c) based on an analysis of events that have occurred and circumstances that have changed since the most recent recoverable amount calculation, the likelihood that a current recoverable amount determination would be less than the asset's carrying amount is remote.

5.5.3 Goodwill

5.5.3.1 CGUs to which goodwill has been allocated

A cash-generating unit to which goodwill has been allocated is tested for impairment both:

a) annually, and

b) whenever there is an indication that the unit may be impaired,

by comparing the carrying amount of the unit, including the goodwill, with the recoverable amount of the unit. If the recoverable amount of the unit exceeds the carrying amount of the unit, the unit and the goodwill allocated to that unit shall be regarded as not impaired. If the carrying amount of the unit exceeds the recoverable amount of the unit, the entity recognises an impairment loss in accordance with the requirement of this standard.

5.5.3.2 Timing of impairment tests

- The annual impairment test for a cash-generating unit to which goodwill has been allocated may be performed at any time during an annual period, provided the test is performed at the same time every year. Different cash-generating units may be tested for impairment at different times.
- However, if some or all of the goodwill allocated to a cash-generating unit was acquired in a business combination during the current annual period, that unit shall be tested for impairment before the end of the current annual period.

5.5.3.3 Individual assets to be tested before CGU to which goodwill has been allocated

- If the assets constituting the CGU to which goodwill has been allocated are tested for impairment at the same time as the unit containing the goodwill, they shall be tested for impairment before the unit containing the goodwill.
- Similarly, if the CGUs constituting a group of CGUs to which goodwill has been allocated are tested for impairment at the same time as the group of units containing the goodwill, the individual units shall be tested for impairment before the group of units containing the goodwill.

- At the time of impairment testing a CGU to which goodwill has been allocated, there may be an indication of an impairment of an asset within the unit containing the goodwill. In such circumstances, the entity tests the asset for impairment first, and recognises any impairment loss for that asset before testing for impairment the cash-generating unit containing the goodwill.
- Similarly, there may be an indication of an impairment of a cash-generating unit within a group of units containing the goodwill. In such circumstances, the entity tests the cash-generating unit for impairment first, and recognises any impairment loss for that unit, before testing for impairment the group of units to which the goodwill is allocated.

5.5.3.4 Rolling forward detailed calculations from a preceding period

The most recent detailed calculation made in a preceding period of the recoverable amount of a cash-generating unit to which goodwill has been allocated may be used in the impairment test of that unit in the current period provided all of the following criteria are met:

a) the assets and liabilities making up the unit have not changed significantly since the most recent recoverable amount calculation;

b) the most recent recoverable amount calculation resulted in an amount that exceeded the carrying amount of the unit by a substantial margin; and

c) based on an analysis of events that have occurred and circumstances that have changed since the most recent recoverable amount calculation, the likelihood that a current recoverable amount determination would be less than the current carrying amount of the unit is remote.

5.5.3.5 CGUs to which it has not been possible to allocate goodwill

- When goodwill relates to a CGU but has not been allocated to that unit, the unit shall be tested for impairment, whenever there is an indication that the unit may be impaired, by comparing the unit's carrying amount, excluding any goodwill, with its recoverable amount. Any impairment loss is recognised in accordance with the requirement of this standard.
- If a CGU as described above includes in its carrying amount an intangible asset that has an indefinite useful life or is not yet available for use and that asset can be tested for impairment only as part of the CGU, the unit also to be tested for impairment annually

5.6 MEASUREMENT OF RECOVERABLE AMOUNT

5.6.1 Recoverable amount

The ***recoverable amount*** of an asset or a CGU is the higher of its fair value less costs of disposal and its value in use.

Higher of

Fair Value less Cost of disposal | Value in use

Illustration 1

The carrying value of a building in the books of Sun Ltd. as at 31st March, 20X1 is ₹ 300 lakh. As on that date the value in use is ₹ 250 lakh and fair value less cost of disposal is ₹ 238 lakh. Calculate the Recoverable Amount.

Solution

Recoverable Amount : Higher of Fair Value less Costs of disposal and Value in Use

Fair Value less costs of disposal : ₹ 250 lakh

Value in Use : ₹ 238 lakh

Therefore, Recoverable value will be ₹ 250 lakh

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5.6.2 Circumstances in which it is not necessary to calculate both an asset's fair value less costs of disposal and its value in use

- If either of these amounts exceeds the asset's carrying amount, the asset is not impaired and it is not necessary to estimate the other amount.
- If there is no basis for making a reliable estimate of fair value less costs of disposal, recoverable amount is measured by reference to value in use alone.
- In some cases, estimates, averages and computational short cuts may provide reasonable approximations of the detailed computations (illustrated in this Standard) for determining fair value less costs of disposal or value in use.

5.6.3 Circumstances in which recoverable amount is determined in the context of CGU

Recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the cash-generating unit to which the asset belongs (refer paragraphs 65–103), unless either:

a) the asset's fair value less costs of disposal is higher than its carrying amount; or

b) the asset's value in use can be estimated to be close to its fair value less costs of disposal and fair value less costs of disposal can be determined.

5.7 FAIR VALUE LESS COSTS OF DISPOSAL

5.7.1 Fair value and costs of disposal – definition

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (Ind AS 113 Fair Value Measurement).

Costs of disposal are incremental costs directly attributable to the disposal of an asset or cash-generating unit, excluding finance costs and income tax expense.

5.7.2 Cost of disposal to be deducted

Costs of disposal, other than those that have been recognised as liabilities, are deducted in determining fair value less costs of disposal. Examples of such costs are legal costs, stamp duty and similar transaction taxes, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale.

However, termination benefits (as defined in Ind AS 19) and costs associated with reducing or reorganising a business following the disposal of an asset are not direct incremental costs to dispose of the asset.

Steps for assessing Fair value *less* costs to sell

First Preference: Binding sale agreement

Second Preference: Active market

Current bid price	If current bid prices not available, the price of the most recent transaction

Third Preference: Best information available at the end of the reporting date

If all the above are not available: Ignore Fair value *less* costs to sell, take Value in use only

5.7.3 Contrasting fair value and value in use

Fair value differs from value in use. Fair value reflects the assumptions market participants would use when pricing the asset. In contrast, value in use reflects the effects of factors that may be specific to the entity and not applicable to entities in general. For example, fair value does not reflect any of the following factors to the extent that they would not be generally available to market participants:

a) additional value derived from the grouping of assets (such as the creation of a portfolio of investment properties in different locations);

b) synergies between the asset being measured and other assets;

c) legal rights or legal restrictions that are specific only to the current owner of the asset; and

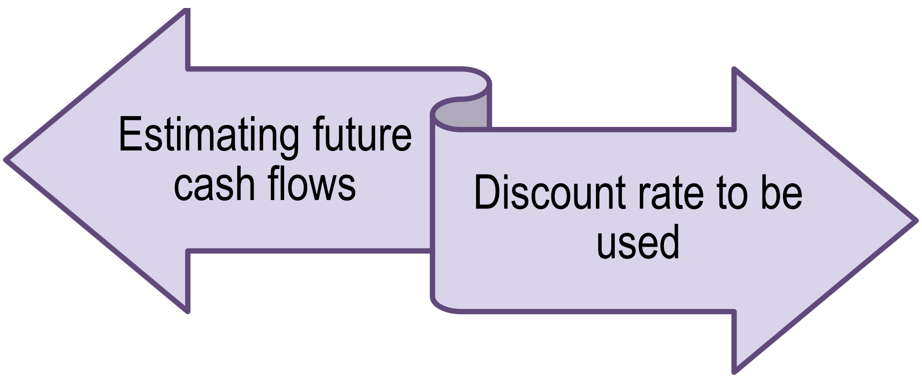
d) tax benefits or tax burdens that are specific to the current owner of the asset.

5.8 VALUE IN USE

5.8.1 Value in use – general

Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.

Primarily two key decisions are involved in determining value in use:



5.8.2 Estimation of expected future cash flows

The following elements shall be reflected in the calculation of an asset's value in use:

a) an estimate of the future cash flows the entity expects to derive from the asset;

b) expectations about possible variations in the amount or timing of those future cash flows;

c) the time value of money, represented by the current market risk-free rate of interest;

d) the price for bearing the uncertainty inherent in the asset; and

e) other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

- **Estimating the value in use of an asset involves the following steps:**

a) estimating the future cash inflows and outflows to be derived from continuing use of the asset and from its ultimate disposal; and

b) applying the appropriate discount rate to those future cash flows.

- The elements identified above in point (b), (d) and (e) can be reflected either as adjustments to the future cash flows or as adjustments to the discount rate. Whichever approach an entity adopts to reflect expectations about possible variations in the amount or timing of future cash flows, the result shall be to reflect the expected present value of the future cash flows, i.e. the weighted average of all possible outcomes.

- **When estimating expected future cash flows, the following rules apply:**

Reasonable and supportable assumptions of management's best estimates of the economic conditions over the remaining useful life of the asset.

Greater weight should be given to external evidence

Most recent financial budgets or forecasts that have been approved by management.

Projections should cover a maximum period of five years, unless a longer period can be justified.

a) Projections of cash flows shall be based on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset. Greater weight shall be given to external evidence.

Management assesses the reasonableness of the assumptions on which its current cash flow projections are based by examining the causes of differences between past cash flow projections and actual cash flows. Management shall ensure that the assumptions on which its current cash flow projections are based are consistent with past actual outcomes, provided the effects of subsequent events or circumstances that did not exist when those actual cash flows were generated make this appropriate.

b) Base cash flow projections on the most recent financial budgets/forecasts approved by management, but shall exclude any estimated future cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance. Projections based on these budgets/forecasts shall cover a maximum period of five years, unless a longer period can be justified.

c) Detailed, explicit and reliable financial budgets/forecasts of future cash flows for periods longer than five years are generally not available. For this reason, management's estimates of future cash flows are based on the most recent budgets/forecasts for a maximum of five years. Management may use cash flow projections based on financial budgets/forecasts over a period longer than five years if it is confident that these projections are reliable and it can demonstrate its ability, based on past experience, to forecast cash flows accurately over that longer period.

d) Estimate cash flow projections beyond the period covered by the most recent budgets/forecasts by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified. This growth rate shall not exceed the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used, unless a higher rate can be justified.

e) Cash flow projections until the end of an asset's useful life are estimated by extrapolating the cash flow projections based on the financial budgets/forecasts using a growth rate for subsequent years. This rate is steady or declining, unless an increase in the rate matches objective information about patterns over a product or industry lifecycle. If appropriate, the growth rate is zero or negative.

f) Estimates of future cash flows and the discount rate reflect consistent assumptions about price increases attributable to general inflation. Therefore, if the discount rate includes the effect of price increases attributable to general inflation, future cash flows are estimated in nominal terms. If the discount rate excludes the effect of price increases attributable to general inflation, future cash flows are estimated in real terms (but include future specific price increases or decreases).

5.8.2.1 Estimates of future cash flows shall include:

a) projections of cash inflows from the continuing use of the asset;

b) projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset (including cash outflows to prepare the asset for use) and can be directly attributed, or allocated on a reasonable and consistent basis, to the asset;

c) net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life. The estimate of net cash flows to be received (or paid) for the disposal of an asset at the end of its useful life shall be the amount that an entity expects to obtain from the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the estimated costs of disposal.

The estimate of net cash flows to be received (or paid) for the disposal of an asset at the end of its useful life is determined in a similar way to an asset's fair value less costs of disposal, except that, in estimating those net cash flows:

(i) an entity uses prices prevailing at the date of the estimate for similar assets that have reached the end of their useful life and have operated under conditions similar to those in which the asset will be used; and

(ii) the entity adjusts those prices for the effect of both future price increases due to general inflation and specific future price increases or decreases. However, if estimates of future cash flows from the asset's continuing use and the discount rate exclude the effect of general inflation, the entity also excludes this effect from the estimate of net cash flows on disposal;

d) projections of cash outflows include those for the day-to-day servicing of the asset as well as future overheads that can be attributed directly, or allocated on a reasonable and consistent basis, to the use of the asset and

e) in the same way that corporate assets can be allocated to a CGU's carrying value, the CGU's cash flows shall also include an appropriate apportionment of corporate overheads when calculating value in use. However, care should be taken around internal charges for using the asset.

5.8.2.2 Estimates of future cash flows shall exclude:

- Estimates of future cash flows do not include:

  (b) cash inflows from assets that generate cash inflows that are largely independent of the cash inflows from the asset under review (for example, financial assets such as receivables);

  (c) cash outflows that relate to obligations that have been recognised as liabilities (for example, payables, pensions or provisions);

  (d) future cash outflows or related cost savings (for example reductions in staff costs) or benefits that are expected to arise from a future restructuring to which an entity is not yet committed.

  Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets,* contains guidance clarifying when an entity is committed to a restructuring.

  When an entity becomes committed to a restructuring, some assets are likely to be affected by this restructuring. Once the entity is committed to the restructuring its estimates of future cash inflows and cash outflows for the purpose of determining value in use reflect the cost savings and other benefits from the restructuring (based on the most recent financial budgets/forecasts approved by management) and its estimates of future cash outflows for the restructuring are included in a restructuring provision in accordance with Ind AS 37;

(e) estimated future cash flows that are expected to arise from improving or enhancing the asset's performance.

Estimates of future cash flows do include future cash flows necessary to maintain the level of economic benefits expected to arise from the asset in its current condition.

When a cash-generating unit consists of assets with different estimated useful lives, all of which are essential to the ongoing operation of the unit, the replacement of assets with shorter lives is considered to be part of the day-to-day servicing of the unit when estimating the future cash flows associated with the unit. Similarly, when a single asset consists of components with different estimated useful lives, the replacement of components with shorter lives is considered to be part of the day-to-day servicing of the asset when estimating the future cash flows generated by the asset;

(f) cash inflows or outflows from financing activities. Estimated future cash flows reflect assumptions that are consistent with the way the discount rate is determined. Otherwise, the effect of some assumptions will be counted twice or ignored.

Because the time value of money is considered by discounting the estimated future cash flows, these cash flows exclude cash inflows or outflows from financing activities;

(g) income tax receipts or payments. Because the discount rate is determined on a pre-tax basis, future cash flows are also estimated on a pre-tax basis; and

(h) when corporate assets have been allocated to a CGU's carrying amount, any internal charges incurred by the CGU for using such assets shall not be included in the CGU's expected future cash flows. To do so would be to double-count the impact of the corporate assets and could result in an impairment loss being recognised incorrectly.

Illustration 2

Saturn India Ltd is reviewing one of its business segments for impairment. The carrying value of its net assets is 40 million. Management has produced two computations for the value-in-use of the business segment. The first value of ₹ 36 million excludes the benefit to be derived from a future reorganization, but the second value of ₹ 44 million includes the benefits to be derived from the future reorganization. There is not an active market for the sale of the business segments.

Whether the business segment needs to be Impaired?

Solution

The benefit of the future reorganization should not be taken into account in calculating value-in-use. Therefore, the net assets of the business segment will be impaired by ₹ 4 million because the value-in-use of ₹ 36 million is lower than the carrying value of ₹ 40 million. The value-in-use can be used as the recoverable amount as there is no active market for the sale of the business segment.

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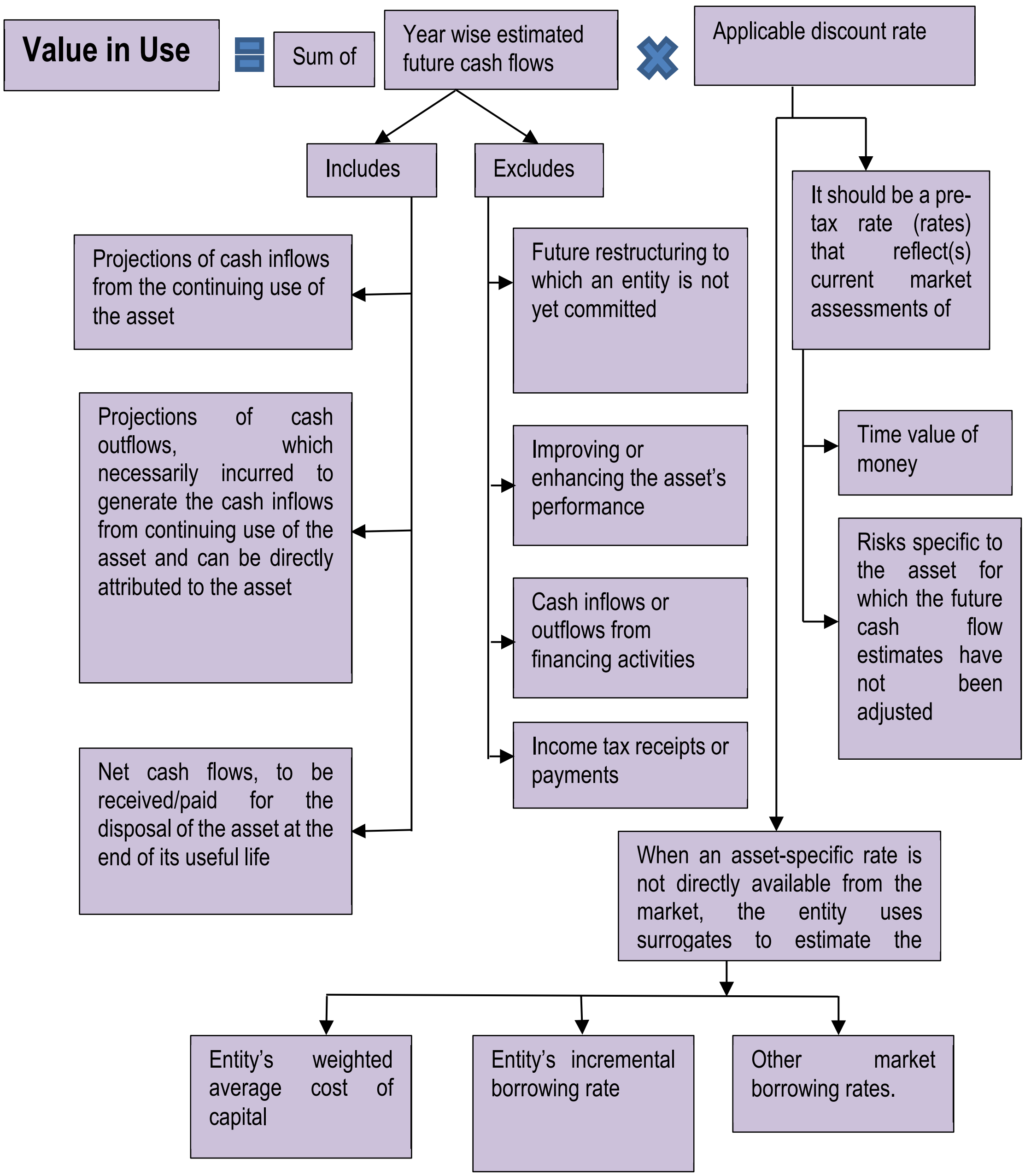
5.8.2.3 Foreign currency future cash flows

Future cash flows are estimated in the currency in which they will be generated and then discounted using a discount rate appropriate for that currency. An entity translates the present value using the spot exchange rate at the date of the value in use calculation.



5.8.3 Discount rate

The discount rate (rates) shall be a pre-tax rate (rates) that reflect(s) current market assessments of:

a) the time value of money; and

b) the risks specific to the asset for which the future cash flow estimates have not been adjusted.

- A rate that reflects current market assessments of the time value of money and the risks specific to the asset is the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the entity expects to derive from the asset.
- This rate is estimated from the rate implicit in current market transactions for similar assets or from the weighted average cost of capital of a listed entity that has a single asset (or a portfolio of assets) similar in terms of service potential and risks to the asset under review. However, the discount rate(s) used to measure an asset's value in use shall not reflect risks for which the future cash flow estimates have been adjusted. Otherwise, the effect of some assumptions will be double-counted.
- When an asset-specific rate is not directly available from the market, an entity uses surrogates to estimate the discount rate. Appendix A provides additional guidance on estimating the discount rate in such circumstances.

The discount rate should be a pre-tax market rate that reflects current market assessments of the:

- time value of money and
- risks specific to the asset

When an asset-specific rate is not directly available from the market, the entity uses surrogates to estimate the discount rates.

- Entity's weighted average cost of capital
- Entity's incremental borrowing rate and
- Other market borrowing rates.

Illustration 3

Mars Ltd. gives the following estimates of cash flows relating to property, plant and equipment on 31st March, 20X4. The discount rate is 15%

Year	*Cash Flow (₹ in lakh)*
20X4-20X5	*2,000*
20X5-20X6	*3,000*
20X6-20X7	*3,000*
20X7-20X8	*4,000*
20X8-20X9	*2,000*
Residual Value at 31st March, 20X9	*500*

Property, plant & equipment was purchased on 1st April, 20X1 for	*₹ 20,000 lakh*
Useful Life was	*8 Years*
Residual Value estimated at the end of 8 years	*₹ 500 lakh*
Fair value less cost to disposal	*₹ 10,000 lakh*

Solution

(a) Calculation of Carrying Amount on 31st March, 20X4 *(₹ in lakh)*

Particular	Amount
Original Cost on 1st April, 20X1	20,000
Less: Depreciation $\frac{(20{,}000-500)}{8}\times 3$	(7,313)
Carrying Amount	12,687

(b) Calculation of Value in Use

Year	Cash Flows	*P.V.*	Amount
20X4-20X5	2,000	.869	1,738
20X5-20X6	3,000	.756	2,268
20X6-20X7	3,000	.658	1,974
20X7-20X8	4,000	.572	2,288
20X8-20X9 (including residual value)	2,500	.497	1,242
Total			**9,510**

(c) Calculation of Recoverable Amount

Particular	Amount
Value in Use	9,510
Fair value less costs of disposal	10,000
Recoverable Amount	10,000

(d) Calculation of Impairment Loss

Carrying Amount – Recoverable Amount

12,687 – 10,000 = 2,687

(e) Calculation of Revised Carrying Amount

Particular	Amount
Carrying Amount	12,687
Less: Impairment Loss	(2,687)
Revised Carrying Amount	10,000

(f) Calculation of Revised Depreciation

$$\frac{\text{Revised Carrying Amount – Residual Value}}{\text{Remaining Life}}$$

$$\frac{10{,}000 - 500}{5} = 1{,}900$$

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5.9 RECOGNISING AND MEASURING AN IMPAIRMENT LOSS

5.9.1 Recognition and measurement of an impairment loss- Individual Asset

If, and only if, the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable amount. That reduction is an impairment loss.

Illustration 4 : Impairment Loss

Jupiter Ltd, a leading manufacturer of steel is having a furnace, which is carried in the balance sheet on 31st March, 20X1 at ₹ 250 lakh. As at that date the value in use and fair value is ₹ 200 lakh. The cost of disposal is ₹ 13 lakh.

Calculate the Impairment Loss to be recognised in the books of the Company?

Solution

Calculation of Impairment Loss:

Calculation of Impairment Loss	*₹ in lakh*
Recoverable Amount =	200
Higher of ,	
Fair Value less Cost of Disposal (200 -13)	187
Or	
Value in Use	200
Impairment Loss = Carrying Amount – Recoverable Amount	
= 250 - 200	50

- An impairment loss shall be recognised immediately in profit or loss, unless the asset is carried at revalued amount in accordance with another Standard (for example, in accordance with the revaluation model in Ind AS 16).
- Any impairment loss of a revalued asset shall be treated as a revaluation decrease in accordance with that other Standard. Impairment loss on a revalued asset is recognised in other comprehensive income to the extent that the impairment loss does not exceed the amount in the revaluation surplus for that same asset. Such an impairment loss on a revalued asset reduces the revaluation surplus for that asset.
- When the amount estimated for an impairment loss is greater than the carrying amount of the asset to which it relates, an entity shall recognise a liability if, and only if, that is required by another Standard.
- After the recognition of an impairment loss, the depreciation (amortisation) charge for the asset is adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.
- If an impairment loss is recognised, any related deferred tax assets or liabilities are determined in accordance with Ind AS 12 by comparing the revised carrying amount of the asset with its tax base.

Illustration 5

Mercury Ltd. has an identifiable asset with a carrying amount of ₹ 1,000. Its recoverable amount is ₹ 650. The tax rate is 30% and the tax base of the asset is ₹ 800. Impairment losses are not deductible for tax purposes. The effect of the impairment loss is as follows:

Solution

	Identifiable assets before impairment loss	*Impairment loss*	*Identifiable assets after impairment loss*
	₹	₹	₹
Carrying amount	1,000	(350)	650
Tax Base	800	-	800
Taxable (deductible) temporary difference	200	(350)	(150)
Deferred tax liability (asset) at 30%	60	(105)	(45)

In accordance with Ind AS 12, the entity recognises the deferred tax asset to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised.

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5.9.2 Recognition and measurement of an impairment loss for a cash-generating unit and goodwill

5.9.2.1 Identification of cash generating units

- A ***cash-generating unit*** is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.
- If there is any indication that an asset may be impaired, recoverable amount shall be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an entity is required to determine the recoverable amount of the cash-generating unit to which the asset belongs (the asset's cash-generating unit).
- The recoverable amount of an individual asset cannot be determined if:

  a) the asset's value in use cannot be estimated to be close to its fair value less costs of disposal (for example, when the future cash flows from continuing use of the asset cannot be estimated to be negligible); and

  b) the asset does not generate cash inflows that are largely independent of those from other assets.
- In such cases, value in use and, therefore, recoverable amount, can be determined only for the asset's cash-generating unit.
- If recoverable amount cannot be determined for an individual asset, an entity identifies the lowest aggregation of assets that generate largely independent cash inflows.

Illustration 6

A mining entity owns a private railway to support its mining activities. The private railway could be sold only for scrap value and it does not generate cash inflows that are largely independent of the cash inflows from the other assets of the mine.

Solution

It is not possible to estimate the recoverable amount of the private railway because its value in use cannot be determined and is probably different from scrap value. Therefore, the entity estimates the recoverable amount of the cash-generating unit to which the private railway belongs, ie the mine as a whole.

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Illustration 7

A bus company provides services under contract with a municipality that requires minimum service on each of five separate routes. Assets devoted to each route and the cash flows from each route can be identified separately. One of the routes operates at a significant loss.

Solution

Since the entity does not have the option to curtail any one bus route, the lowest level of identifiable cash inflows that are largely independent of the cash inflows from other assets or groups of assets is the cash inflows generated by the five routes together. The cash-generating unit for each route is the bus company as a whole.

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5.9.2.2 Relevance of internal management reporting to the identification of CGUs

Cash inflows are inflows of cash and cash equivalents received from parties external to the entity. In identifying whether cash inflows from an asset (or group of assets) are largely independent of the cash inflows from other assets (or groups of assets), an entity considers various factors including how management monitors the entity's operations or how management makes decisions about continuing or disposing of the entity's assets and operations.

5.9.2.3 Active market exists for the output produced by an asset or group of assets

- If an active market exists for the output produced by an asset or group of assets, that asset or group of assets shall be identified as a cash-generating unit, even if some or all of the output is used internally.
- Even if part or all of the output produced by an asset or a group of assets is used by other units of the entity, this asset or group of assets forms a separate cash-generating unit if the entity could sell the output on an active market. This is because the asset or group of assets could generate cash inflows that would be largely independent of the cash inflows from other assets or groups of assets.

- If the cash inflows generated by any asset or cash-generating unit are affected by internal transfer pricing, an entity shall use management's best estimate of future price(s) that could be achieved in arm's length transactions in estimating:

  a) the future cash inflows used to determine the asset's or cash-generating unit's value in use; and

  b) the future cash outflows used to determine the value in use of any other assets or cash-generating units that are affected by the internal transfer pricing.

5.9.2.4 Cash-generating units to be identified consistently from period to period

- Cash-generating units shall be identified consistently from period to period for the same asset or types of assets, unless a change is justified.

- If an entity determines that an asset belongs to a cash-generating unit different from that in previous periods, or that the types of assets aggregated for the asset's cash-generating unit have changed, disclosures are required about the cash-generating unit, if an impairment loss is recognised or reversed for the cash-generating unit.

5.9.2.5 Allocation of assets and liabilities to CGUs

- The **recoverable amount** of a cash-generating unit is the higher of the cash-generating unit's fair value less costs of disposal and its value in use.

- ***Carrying amount*** is the amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon. The carrying amount of a cash-generating unit shall be determined on a basis consistent with the way the recoverable amount of the cash-generating unit is determined.

- The carrying amount of a cash-generating unit:

  a) includes the carrying amount of only those assets that can be attributed directly, or allocated on a reasonable and consistent basis, to the cash-generating unit and will generate the future cash inflows used in determining the cash-generating unit's value in use; and

  b) does not include the carrying amount of any recognised liability, unless the recoverable amount of the cash-generating unit cannot be determined without consideration of this liability.

  This is because fair value less costs of disposal and value in use of a cash-generating unit are determined excluding cash flows that relate to assets that are not part of the cash-generating unit and liabilities that have been recognised.

- In some cases, although some assets contribute to the estimated future cash flows of a cash-generating unit, they cannot be allocated to the cash-generating unit on a reasonable and consistent basis. This might be the case for goodwill or corporate assets such as head office assets.

- It may be necessary to consider some recognised liabilities to determine the recoverable amount of a cash-generating unit. This may occur if the disposal of a cash-generating unit would require the buyer to assume the liability. In this case, the fair value less costs of disposal (or the estimated cash flow from ultimate disposal) of the cash-generating unit is the estimated selling price for the assets of the cash-generating unit and the liability together, less the costs of disposal. To perform a meaningful comparison between the carrying amount of the cash-generating unit and its recoverable amount, the carrying amount of the liability is deducted in determining both the cash-generating unit's value in use and its carrying amount.

Illustration 8

A company operates a mine in a country where legislation requires that the owner must restore the site on completion of its mining operations. The cost of restoration includes the replacement of the overburden, which must be removed before mining operations commence. A provision for the costs to replace the overburden was recognised as soon as the overburden was removed. The amount provided was recognised as part of the cost of the mine and is being depreciated over the mine's useful life. The carrying amount of the provision for restoration costs is ₹ 500, which is equal to the present value of the restoration costs.

The entity is testing the mine for impairment. The cash-generating unit for the mine is the mine as a whole. The entity has received various offers to buy the mine at a price of around ₹ 800. This price reflects the fact that the buyer will assume the obligation to restore the overburden. Disposal costs for the mine are negligible. The value in use of the mine is approximately ₹ 1,200, excluding restoration costs. The carrying amount of the mine is ₹ 1,000.

Solution

The cash-generating unit's fair value less costs of disposal is ₹ 800. This amount considers restoration costs that have already been provided for. As a consequence, the value in use for the cash-generating unit is determined after consideration of the restoration costs and is estimated to be ₹ 700 (₹ 1,200 less ₹ 500). The carrying amount of the cash-generating unit is ₹ 500, which is the carrying amount of the mine (₹ 1,000) less the carrying amount of the provision for restoration costs (₹ 500). Therefore, the recoverable amount of the cash-generating unit exceeds its carrying amount.

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- For practical reasons, the recoverable amount of a cash-generating unit is sometimes determined after consideration of assets that are not part of the cash-generating unit (for example, receivables or other financial assets) or liabilities that have been recognised (for example, payables, pensions and other provisions). In such cases, the carrying amount of the cash-generating unit is increased by the carrying amount of those assets and decreased by the carrying amount of those liabilities.

5.9.2.6 Allocating goodwill to cash-generating units

- For the purpose of impairment testing, goodwill acquired in a business combination shall, from the acquisition date, be allocated to each of the acquirer's cash-generating units, or groups of cash-generating units, that is expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units.
- Goodwill sometimes cannot be allocated on a non-arbitrary basis to individual cash-generating units, but only to groups of cash-generating units. Each unit or group of units to which the goodwill is so allocated:
  a) represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and
  b) not be larger than an operating segment as defined by paragraph 5 of Ind AS 108 *Operating Segments* before aggregation.
- Goodwill recognised in a business combination is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised. Goodwill does not generate cash flows independently of other assets or groups of assets and, therefore, it will always be tested for impairment as part of a CGU or a group of CGUs.
- If the initial allocation of goodwill acquired in a business combination cannot be completed before the end of the annual period in which the business combination is effected, that initial allocation shall be completed before the end of the first annual period beginning after the acquisition date.
- In accordance with Ind AS 103 *Business Combinations*, if the initial accounting for a business combination can be determined only provisionally by the end of the period in which the combination is effected, the acquirer:
  a) accounts for the combination using those provisional values; and
  b) recognises any adjustments to those provisional values as a result of completing the initial accounting within the measurement period, which will not exceed twelve months from the acquisition date.

  In such circumstances, it might also not be possible to complete the initial allocation of the goodwill recognised in the combination before the end of the annual period in which the combination is affected. When this is the case, the entity discloses the information required by this standard.
- If goodwill has been allocated to a cash-generating unit and the entity disposes of an operation within that unit, the goodwill associated with the operation disposed of shall be:
  a) included in the carrying amount of the operation when determining the gain or loss on disposal; and

b) measured on the basis of the relative values of the operation disposed of and the portion of the cash-generating unit retained, unless the entity can demonstrate that some other method better reflects the goodwill associated with the operation disposed of.

Illustration 9

An entity sells for ₹ 100 an operation that was part of a cash-generating unit to which goodwill has been allocated. The goodwill allocated to the unit cannot be identified or associated with an asset group at a level lower than that unit, except arbitrarily. The recoverable amount of the portion of the cash-generating unit retained is ₹ 300.

Solution

Since the goodwill allocated to the cash-generating unit cannot be non-arbitrarily identified or associated with an asset group at a level lower than that unit, the goodwill associated with the operation disposed of is measured on the basis of the relative values of the operation disposed of and the portion of the unit retained. Therefore, 25 per cent of the goodwill allocated to the cash-generating unit is included in the carrying amount of the operation that is sold.

If an entity reorganises its reporting structure in a way that changes the composition of one or more cash-generating units to which goodwill has been allocated, the goodwill shall be reallocated to the units affected. This reallocation is performed by using a relative value approach similar to that used when an entity disposes of an operation within a cash-generating unit, unless the entity can demonstrate that some other method better reflects the goodwill associated with the reorganised units.

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Illustration 10

Goodwill had previously been allocated to cash-generating unit A. The goodwill allocated to A cannot be identified or associated with an asset group at a level lower than A, except arbitrarily. A is to be divided and integrated into three other cash-generating units, B, C and D.

Solution

Since the goodwill allocated to A cannot be non-arbitrarily identified or associated with an asset group at a level lower than A, it is reallocated to units B, C and D on the basis of the relative values of the three portions of A before those portions are integrated with B, C and D.

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5.9.2.7 Allocating corporate assets to cash-generating units

- ***Corporate assets*** are assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units. Corporate assets include group or divisional assets such as the building of a headquarters or a division of the entity, EDP equipment or a research centre. The structure of an entity determines whether an asset meets this Standard's definition of corporate assets for a particular cash-generating unit.

- The distinctive characteristics of corporate assets are that:
  a) they do not generate cash inflows independently of other assets or groups of assets; and
  b) their carrying amount cannot be fully attributed to the cash-generating unit under review.
- Because corporate assets do not generate separate cash inflows, they are tested for impairment in the context of the CGU or group of CGUs to which the asset belongs. In testing a cash-generating unit for impairment, an entity shall identify all the corporate assets that relate to the cash-generating unit under review. If a portion of the carrying amount of a corporate asset:
  a) can be allocated on a reasonable and consistent basis to that unit, the entity compares the carrying amount of the unit, including the portion of the carrying amount of the corporate asset allocated to the unit, with its recoverable amount. Any impairment loss is recognised in accordance with the requirement of this standard.
  b) cannot be allocated on a reasonable and consistent basis to that unit, the entity:
     (i) compares the carrying amount of the unit, excluding the corporate asset, with its recoverable amount and recognise any impairment loss in accordance with the requirement of this standard;
     (ii) identify the smallest group of cash-generating units that includes the cash-generating unit under review and to which a portion of the carrying amount of the corporate asset can be allocated on a reasonable and consistent basis; and
     (iii) compare the carrying amount of that group of cash-generating units, including the portion of the carrying amount of the corporate asset allocated to that group of units, with the recoverable amount of the group of units. Any impairment loss shall be recognised in accordance with the requirement of this standard.

Illustration 11

Earth Infra Ltd has two cash-generating units, X and Y. There is no goodwill within the units' carrying values. The carrying values of the CGUs are CGU A for ₹ 20 million and CGU B for ₹ 30 million. The company has an office building which it is using as an office headquarter and has not been included in the above values and can be allocated to the units on the basis of their carrying values. The office building has a carrying value of ₹ 10 million. The recoverable amounts are based on value-in-use of ₹ 18 million for CGU A and ₹ 38 million for CGU B.

Determine whether the carrying values of CGU A and B are impaired.

Solution

The office building is a corporate asset which needs to be allocated to CGU A and B on a reasonable and consistent basis:

	A	B	Total
Carrying value of CGUs	20	30	50
Allocation of office building	4	6	10
(office building is allocated in the ratio of Carrying value of CGU's)	___	___	___
Carrying value of CGU after			
Allocation of corporate asset	24	36	60
Recoverable Amount	18	38	56
Impairment Loss	6	-	

The impairment loss will be allocated on the basis of 4/24 against the building (₹ 1 million) and 20/24 against the other assets (₹ 5 million).

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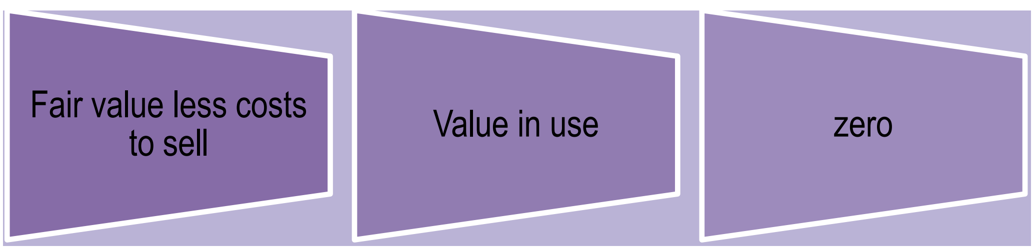
5.9.2.8 Recognition and measurement of an impairment loss for a cash-generating unit

- An impairment loss is recognised for a cash-generating unit (the smallest group of cash-generating units to which goodwill or a corporate asset has been allocated) if, and only if, the recoverable amount of the unit (group of units) is less than the carrying amount of the unit (group of units). The impairment loss is allocated to reduce the carrying amount of the assets of the unit (group of units) in the following order:

  a) first, to reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and

  b) then, to the other assets of the unit (group of units) pro rata on the basis of the carrying amount of each asset in the unit (group of units).

- In allocating an impairment loss to individual assets within a CGU, the carrying amount of an individual shall not be reduce below the highest of:



- The amount of the impairment loss that would otherwise have been allocated to the asset shall be allocated pro rata to the other assets of the unit (group of units).

- If the recoverable amount of an individual asset cannot be determined:

  a) an impairment loss is recognised for the asset if its carrying amount is greater than the higher of its fair value less costs of disposal and the results of the allocation procedures described; and

  b) no impairment loss is recognised for the asset if the related cash-generating unit is not impaired. This applies even if the asset's fair value less costs of disposal is less than its carrying amount.

Illustration 12

A machine has suffered physical damage but is still working, although not as well as before it was damaged. The machine's fair value less costs of disposal is less than its carrying amount. The machine does not generate independent cash inflows. The smallest identifiable group of assets that includes the machine and generates cash inflows that are largely independent of the cash inflows from other assets is the production line to which the machine belongs. The recoverable amount of the production line shows that the production line taken as a whole is not impaired.

Assumption 1: budgets/forecasts approved by management reflect no commitment of management to replace the machine.

Assumption 2: budgets/forecasts approved by management reflect a commitment of management to replace the machine and sell it in the near future. Cash flows from continuing use of the machine until its disposal are estimated to be negligible.

Solution

1. The recoverable amount of the machine alone cannot be estimated because the machine's value in use:

   a) may differ from its fair value less costs of disposal; and

   b) can be determined only for the cash-generating unit to which the machine belongs (the production line).

   The production line is not impaired. Therefore, no impairment loss is recognised for the machine. Nevertheless, the entity may need to reassess the depreciation period or the depreciation method for the machine. Perhaps a shorter depreciation period or a faster depreciation method is required to reflect the expected remaining useful life of the machine or the pattern in which economic benefits are expected to be consumed by the entity.

2. The machine's value in use can be estimated to be close to its fair value less costs of disposal. Therefore, the recoverable amount of the machine can be determined and no consideration is given to the cash-generating unit to which the machine belongs (i.e. the production line). Because the machine's fair value less costs of disposal is less than its carrying amount, an impairment loss is recognised for the machine.

After the allocation procedures have been applied, a liability is recognised for any remaining amount of an impairment loss for a cash-generating unit if, and only if, that is required by another Indian Accounting Standard.

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5.9.3 Two-step approach for goodwill allocated to a group of CGUs

When goodwill is allocated to a group of CGUs for the purpose of impairment testing but cannot be allocated on a non-arbitrary basis to individual CGUs, the individual CGUs must be tested for impairment before the group of CGUs containing the associated goodwill.

5.10 REVERSING AN IMPAIRMENT LOSS

5.10.1 Reversals of impairment losses – general

- An entity is required to assess at the end of each reporting period whether there is any indication that an impairment loss recognised in prior periods for an asset other than goodwill may no longer exist or may have decreased. If any such indication exists, the entity shall estimate the recoverable amount of that asset.
- An impairment loss recognised for goodwill shall not be reversed in a subsequent period.
- An impairment loss recognised in prior periods for an asset other than goodwill shall be reversed if, and only if, there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. If this is the case, the carrying amount of the asset is, except as described in paragraph 117, increased to its recoverable amount.
- A reversal of an impairment loss reflects an increase in the estimated service potential of an asset, either from use or from sale, since the date when an entity last recognised an impairment loss for that asset. Examples of changes in estimates include:
  a) a change in the basis for recoverable amount (ie whether recoverable amount is based on fair value less costs of disposal or value in use);
  b) if recoverable amount was based on value in use, a change in the amount or timing of estimated future cash flows or in the discount rate; or
  c) if recoverable amount was based on fair value less costs of disposal, a change in estimate of the components of fair value less costs of disposal.
- An asset's value in use may become greater than the asset's carrying amount simply because the present value of future cash inflows increases as they become closer. However, the service potential of the asset has not increased. Therefore, an impairment loss is not reversed just because of the passage of time (sometimes called the 'unwinding' of the discount), even if the recoverable amount of the asset becomes higher than its carrying amount.

5.10.2 Indications of reversals of impairment loss

In assessing whether there is any indication that an impairment loss recognised in prior periods for an asset other than goodwill may no longer exist or may have decreased, an entity shall consider, as a minimum, the following indications:

5.10.2.1 External sources of information

a) there are observable indication that the asset's value has increased significantly during the period;

b) significant changes with a favorable effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which the asset is dedicated; and

c) market interest rates or other market rates of return on investments have decreased during the period, and those decreases are likely to affect the discount rate used in calculating the asset's value in use and increase the asset's recoverable amount materially.

5.10.2.2 Internal sources of information

a) significant changes with a favourable effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, the asset is used or is expected to be used. These changes include costs incurred during the period to improve or enhance the asset's performance or restructure the operation to which the asset belongs; and

b) evidence is available from internal reporting that indicates that the economic performance of the asset is, or will be, better than expected.

- If there is an indication that an impairment loss recognised for an asset other than goodwill may no longer exist or may have decreased, this may indicate that the remaining useful life, the depreciation (amortisation) method or the residual value may need to be reviewed and adjusted in accordance with the Indian Accounting Standard applicable to the asset, even if no impairment loss is reversed for the asset.

5.10.3 Reversing an impairment loss for an individual asset

- The increased carrying amount of an asset other than goodwill attributable to a reversal of an impairment loss shall not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years. Any increase in excess of this amount would be a revaluation and would be accounted for under the appropriate Standard (e.g. Ind AS 16 Property, Plant and Equipment).
- A reversal of an impairment loss for an asset other than goodwill is recognised immediately in profit or loss, unless the asset is carried at revalued amount in accordance with another Indian Accounting Standard. Any reversal of an impairment loss of a revalued asset shall be treated as a revaluation increase in accordance with that other Indian Accounting Standard.

- A reversal of an impairment loss on a revalued asset is recognised in other comprehensive income and increases the revaluation surplus for that asset. However, to the extent that an impairment loss on the same revalued asset was previously recognised in profit or loss, a reversal of that impairment loss is also recognised in profit or loss.
- After a reversal of an impairment loss is recognised, the depreciation (amortisation) charge for the asset is adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

5.10.4 Reversing an impairment loss for a cash-generating unit

- A reversal of an impairment loss for a cash-generating unit shall be allocated to the assets of the unit, except for goodwill, pro rata with the carrying amounts of those assets. These increases in carrying amounts shall be treated as reversals of impairment losses for individual assets and recognised as discussed above.
- In allocating a reversal of an impairment loss for a cash-generating unit, the carrying amount of an asset shall not be increased above the lower of:

  a) its recoverable amount (if determinable); and

  b) the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior periods.
- The amount of the reversal of the impairment loss that would otherwise have been allocated to the asset is allocated pro rata to the other assets of the unit, except for goodwill.

5.10.5 Reversing an impairment loss for goodwill not permitted

- An impairment loss recognised for goodwill shall not be reversed in a subsequent period.
- Ind AS 38 *Intangible Assets* prohibits the recognition of internally generated goodwill. Any increase in the recoverable amount of goodwill in the periods following the recognition of an impairment loss for that goodwill is likely to be an increase in internally generated goodwill, rather than a reversal of the impairment loss recognised for the acquired goodwill.

Illustration 13: Reversal of Impairment Loss

On 1st April 20X1, Venus Ltd acquired 100% of Saturn Ltd for ₹ 4,00,000. The fair value of the net identifiable assets of Saturn Ltd was ₹ 3,20,000 and goodwill was ₹ 80,000. Saturn Ltd is in coal mining business. On 31st March, 20X3, the government has cancelled licenses given to it in few states.

As a result Saturn's Ltd revenue is estimated to get reduce by 30%. The adverse change in market place and regulatory conditions is an indicator of impairment. As a result, Venus Ltd has to estimate the recoverable amount of goodwill and net assets of Saturn Ltd on 31st March, 20X3.

Venus Ltd uses straight line depreciation. The useful life of Saturn's Ltd assets is estimated to be 20 years with no residual value. No independent cash inflows can be identified to any individual assets. So the entire operation of Saturn Ltd is to be treated as a CGU. Due to the regulatory entangle it is not possible to determine the selling price of Saturn Ltd as a CGU. Its value in use is estimated by the management at ₹ 2,12,000.

Suppose by 31st March, 20X5 the government reinstates the licenses of Saturn Ltd. The management expects a favourable change in net cash flows. This is an indicator that an impairment loss may have reversed. The recoverable amount of Saturn's Ltd net asset is re-estimated. The value in use is expected to be ₹ 3,04,000 and fair value less cost to disposal is expected to be ₹ 2,90,000.

Solution

Since the fair value less costs of disposal is not determinable the recoverable amount of the CGU is its value in use. The carrying amount of the assets of the CGU on 31st March, 20X3 is as follows:

Calculation of Impairment loss

			₹
	Goodwill	**Other assets**	**Total**
Historical Cost	80,000	3,20,000	4,00,000
Accumulated Depreciation (3,20,000/20) x 2	-	(32,000)	(32,000)
Carrying Amount	80,000	2,88,000	3,68,000
Impairment Loss	(80,000)	(76,000)	(1,56,000)

Revised Carrying Amount

- Impairment Loss = Carrying Amount – Recoverable Amount (₹ 3,68,000 - ₹ 2,12,000) = ₹ 1,56,000 is charged in statement of profit and loss for the period ending 31st March, 20X3 as impairment loss.
- Impairment loss is allocated first to goodwill ₹ 80,000 and remaining loss of ₹ 76,000 (₹ 1,56,000 – ₹ 80,000) is allocated to the other assets.

Reversal of Impairment loss

Reversal of impairment loss is recognised subject to:-

- The impairment loss on goodwill cannot be reversed.
- The increased carrying amount of an asset after reversal of an impairment loss not to exceed the carrying amount that would have been determined had no impairment loss been recognised in prior years.

Calculation of carrying amount of identifiable assets had no impairment loss is recognised

	₹
Historical Cost	3,20,000
Accumulated Depreciation for 4 years (3,20,000/20) x 4	(64,000)
Carrying amount had no impairment loss is recognised on 31st March, 20X5	2,56,000

Carrying amount of other assets after recognition of impairment loss

	₹
Carrying amount on 31st March, 20X3	2,12,000
Accumulated Depreciation for 2 years (2,12,000/18) x 2 [rounded off to nearest thousand for ease of calculation]	(24,000)
Carrying amount on 31st March, 20X5	1,88,000

- The impairment loss recognised previously can be reversed only to the extent of lower of re-estimated recoverable amount is ₹ 2,56,000 (higher of fair value less costs of disposal ₹ 2,90,000 and value in use ₹ 3,04,000)
- Impairment loss reversal will be ₹ 68,000 i.e. (₹ 2,56,000 – ₹ 1,88,000). This amount is recognised as income in the statement of profit and loss for the year ended 31st March, 20X5.
- The carrying amount of other assets at 31st March, 20X5 after reversal of impairment loss will be ₹ 2,56,000.
- From 1st April, 20X5 the depreciation charge will be ₹ 16,000 i.e. (₹ 2,56,000/16)

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5.11 DISCLOSURE

5.11.1 Disclosure – general

- An entity is required to disclose the following for each class of assets:
  a) the amount of impairment losses recognised in profit or loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are included;
  b) the amount of reversals of impairment losses recognised in profit or loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are reversed;

c) the amount of impairment losses on revalued assets recognised in other comprehensive income during the period; and

d) the amount of reversals of impairment losses on revalued assets recognised in other comprehensive income during the period.

- The information required as above may be presented with other information disclosed for the class of assets. For example, this information may be included in a reconciliation of the carrying amount of property, plant and equipment, at the beginning and end of the period, as required by Ind AS 16.

5.11.2 Entities reporting segment information

- An entity that reports segment information in accordance with Ind AS 108 shall disclose the following for each reportable segment:

a) the amount of impairment losses recognised in profit or loss and in other comprehensive income during the period; and

b) the amount of reversals of impairment losses recognised in profit or loss and in other comprehensive income during the period.

5.11.3 Impairment losses recognised or reversed in the period

- An entity is required to disclose the following for each material impairment loss recognised or reversed during the period for an individual asset, including goodwill, or a cash-generating unit:

a) the events and circumstances that led to the recognition or reversal of the impairment loss;

b) the amount of the impairment loss recognised or reversed;

c) for an individual asset:

(i) the nature of the asset; and

(ii) if the entity reports segment information in accordance with Ind AS 108, the reportable segment to which the asset belongs;

d) for a cash-generating unit:

(i) a description of the cash-generating unit (such as whether it is a product line, a plant, a business operation, a geographical area, or a reportable segment as defined in Ind AS 108);

(ii) the amount of the impairment loss recognised or reversed by class of assets and, if the entity reports segment information in accordance Ind AS 108, by reportable segment; and

(iii) if the aggregation of assets for identifying the cash-generating unit has changed since the previous estimate of the cash-generating unit's recoverable amount (if any), a description of the current and former way of aggregating assets and the reasons for changing the way the cash-generating unit is identified;

e) the recoverable amount of the asset or CGU, and whether the recoverable amount of the asset (cash-generating unit) is its fair value less costs of disposal or its value in use;

f) if recoverable amount is fair value less costs of disposal, the entity shall disclose the following information:

(i) the level of the fair value hierarchy (refer Ind AS 113) within which the fair value measurement of the asset (cash-generating unit) is categorised in its entirety (without taking into account whether the 'costs of disposal' are observable);

(ii) for fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) used to measure fair value less costs of disposal. If there has been a change in valuation technique, the entity shall disclose that change and the reason(s) for making it; and

(iii) for fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, each key assumption on which management has based its determination of fair value less costs of disposal. Key assumptions are those to which the asset's (cash-generating unit's) recoverable amount is most sensitive. The entity shall also disclose the discount rate(s) used in the current measurement and previous measurement if fair value less costs of disposal is measured using a present value technique.

g) if recoverable amount is value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value in use.

5.11.4 Other impairment losses/reversals material in aggregate to the financial statements

An entity shall disclose the following information for the aggregate impairment losses and the aggregate reversals of impairment losses recognised during the period for which no information is disclosed in above paragraph:

a) the main classes of assets affected by impairment losses and the main classes of assets affected by reversals of impairment losses; and

b) the main events and circumstances that led to the recognition of these impairment losses and reversals of impairment losses.

5.11.5 Unallocated goodwill

If any portion of the goodwill acquired in a business combination during the period has not been allocated to a cash-generating unit (group of units) at the end of the reporting period, the amount of the unallocated goodwill shall be disclosed together with the reasons why that amount remains unallocated.

5.11.6 Information to be disclosed for CGUs to which significant goodwill or indefinite – life intangible assets have been allocated

An entity is required to disclose the following information for each cash-generating unit (group of units) for which the carrying amount of goodwill or intangible assets with indefinite useful lives allocated to that unit (group of units) is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives:

a) the carrying amount of goodwill allocated to the unit (group of units);

b) the carrying amount of intangible assets with indefinite useful lives allocated to the unit (group of units);

c) the basis on which the unit's (group of units') recoverable amount has been determined (ie value in use or fair value less costs of disposal);

d) if the unit's (group of units') recoverable amount is based on value in use:

   (i) each key assumption on which management has based its cash flow projections for the period covered by the most recent budgets/forecasts. Key assumptions are those to which the unit's (group of units') recoverable amount is most sensitive.

   (ii) a description of management's approach to determining the value(s) assigned to each key assumption, whether those value(s) reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information.

   (iii) the period over which management has projected cash flows based on financial budgets/forecasts approved by management and, when a period greater than five years is used for a cash-generating unit (group of units), an explanation of why that longer period is justified.

   (iv) the growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets/forecasts, and the justification for using any growth rate that exceeds the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market to which the unit (group of units) is dedicated.

   (v) the discount rate(s) applied to the cash flow projections.

e) if the unit's (group of units') recoverable amount is based on fair value less costs of disposal, the valuation technique(s) used to measure fair value less costs of disposal. An entity is not required to provide the disclosures required by Ind AS 113. If fair value less costs of disposal is not measured using a quoted price for an identical unit (group of units), an entity shall disclose the following information:

(i) each key assumption on which management has based its determination of fair value less costs of disposal. Key assumptions are those to which the unit's (group of units') recoverable amount is most sensitive;

(ii) a description of management's approach to determining the value (or values) assigned to each key assumption, whether those values reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information;

(iii) the level of the fair value hierarchy (see Ind AS 113 within which the fair value measurement is categorised in its entirety (without giving regard to the observability of 'costs of disposal'); and

(iv) if there has been a change in valuation technique, the change and the reason(s) for making it. If fair value less costs of disposal is measured using discounted cash flow projections, an entity shall disclose the following information:

(v) the period over which management has projected cash flows;

(vi) the growth rate used to extrapolate cash flow projections; and

(vii) the discount rate(s) applied to the cash flow projections.

f) if a reasonably possible change in a key assumption on which management has based its determination of the unit's (group of units') recoverable amount would cause the unit's (group of units') carrying amount to exceed its recoverable amount:

(i) the amount by which the unit's (group of units') recoverable amount exceeds its carrying amount;

(ii) the value assigned to the key assumption; and

(iii) the amount by which the value assigned to the key assumption must change, after incorporating any consequential effects of that change on the other variables used to measure recoverable amount, in order for the unit's (group of units') recoverable amount to be equal to its carrying amount.

5.11.7 Information to be disclosed for CGUs to which insignificant goodwill or indefinite-life intangible assets have been allocated

- If some or all of the carrying amount of goodwill or intangible assets with indefinite useful lives is allocated across multiple cash-generating units (groups of units), and the amount so allocated to each unit (group of units) is not significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives, that fact shall be disclosed, together with the aggregate carrying amount of goodwill or intangible assets with indefinite useful lives allocated to those units (groups of units).

- In addition, if the recoverable amounts of any of those units (groups of units) are based on the same key assumption(s) and the aggregate carrying amount of goodwill or intangible assets with indefinite useful lives allocated to them is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives, an entity shall disclose that fact, together with:

  a) the aggregate carrying amount of goodwill allocated to those units (groups of units);

  b) the aggregate carrying amount of intangible assets with indefinite useful lives allocated to those units (groups of units);

  c) a description of the key assumption(s);

  d) a description of management's approach to determining the value(s) assigned to the key assumption(s), whether those value(s) reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information; and

  e) if a reasonably possible change in the key assumption(s) would cause the aggregate of the units' (groups of units') carrying amounts to exceed the aggregate of their recoverable amounts:

     (i) the amount by which the aggregate of the units' (groups of units') recoverable amounts exceeds the aggregate of their carrying amounts;

     (ii) the value(s) assigned to the key assumption(s); and

     (iii) the amount by which the value(s) assigned to the key assumption(s) must change, after incorporating any consequential effects of the change on the other variables used to measure recoverable amount, in order for the aggregate of the units' (groups of units') recoverable amounts to be equal to the aggregate of their carrying amounts.

- The most recent detailed calculation made in a preceding period of the recoverable amount of a cash-generating unit (group of units) may, in accordance with paragraph 24 or 99, be carried forward and used in the impairment test for that unit (group of units) in the current period provided specified criteria are met. When this is the case, the information for that unit (group of units) that is incorporated into the disclosures required by paragraphs 134 and 135 relate to the carried forward calculation of recoverable amount.

Illustration 14

From the following details of an asset, find out:

(a) Impairment loss and its treatment.

(b) Current year depreciation for the year end.

Particulars of assets:

Cost of asset	*₹ 56 lakh*
Useful life	*10 years*
Salvage value	*Nil*
Carrying value at the beginning of the year	*₹ 27.30 lakh*
Remaining useful life	*3 years*
Recoverable amount at the beginning of the year	*₹ 12 lakh*
Upward revaluation done in last year	*₹ 14 lakh*

Solution

Impairment loss

Impairment loss = Carrying amount of the asset – Recoverable amount

= ₹ 27.30 lakh – ₹ 12 lakh

= ₹ 15.30 lakh

Treatment of impairment loss

As per Ind AS 36, impairment loss (whether of an individual asset of a CGU) is recognised in the following manner:

(a) *Impairment loss of a revalued asset*: It is recognised in other comprehensive income to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset. The balance, if any, is recognised as an expense in the statement of profit and loss.

(b) *Impairment loss of other assets*: Impairment loss of any other asset should be recognised as an expense in the statement of profit and loss.

Since, the asset in question has been revalued upwards, the impairment loss will be adjusted first against the revaluation surplus of ₹ 14 lakh. The balance amount of ₹ 1.30 lakh will be recognised as an expense in the profit and loss account.

Current year depreciation

Revised carrying amount (after recognising impairment loss)	₹ 12 lakh
Remaining useful life	3 years

Salvage value	Nil
Annual depreciation (12/3)	₹ 4 lakh

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Illustration 15

Venus Ltd. has an asset, which is carried in the Balance Sheet on 31st March, 20X1 at ₹ 500 lakh. As at that date the value in use is ₹ 400 lakh and the fair value less costs to sells is ₹ 375 lakh.

From the above data:

(a) Calculate impairment loss.

(b) Prepare journal entries for adjustment of impairment loss.

(c) Show, how impairment loss will be shown in the Balance Sheet.

Solution

According to Ind AS 36, *Impairment of Assets*, impairment loss is the excess of 'Carrying amount of the asset' over 'Recoverable Amount'.

In the present case, the impairment loss can be computed in the following manner: Step 1: Fair value *less* costs to sell: ₹ 375 lakh

Step 2: Value in use: ₹ 400 lakh

Step 3: Recoverable amount, i.e., higher of 'fair value *less* costs to sell' & 'value in use'.

Thus, recoverable amount is ₹ 400 lakh

Step 4: Carrying amount of the asset ₹ 500 lakh

Step 5: Impairment loss, i.e., excess of amount computed in step 4 over amount computed in Step 3.

₹ 100 lakh (being the difference between ₹ 500 lakh and ₹ 400 lakh).

According to Ind AS 36, an impairment loss should be recognised as an expense in the statement of profit and loss immediately, unless the asset is carried at revalued amount in accordance with another Accounting Standard. Assuming, that the asset is not carried at revalued amount, the impairment loss of ₹ 100 lakh will be charged to Profit & Loss Account.

Journal Entries

Date	Particulars		Dr. Amt.	Cr. Amt.
				₹ in lakh
31.3.20X1	Impairment Loss A/c	Dr.	100	
	To Assets A/c			100
	(Being impairment loss on an asset recognised)			
31.3.20X1	Statement of Profit & Loss	Dr.	100	

	To Impairment Loss A/c (Being impairment loss transferred to statement of profit and loss)		100

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Illustration 16

A publisher owns 150 magazine titles of which 70 were purchased and 80 were self-created. The price paid for a purchased magazine title is recognised as an intangible asset. The costs of creating magazine titles and maintaining the existing titles are recognised as an expense when incurred. Cash inflows from direct sales and advertising are identifiable for each magazine title. Titles are managed by customer segments. The level of advertising income for a magazine title depends on the range of titles in the customer segment to which the magazine title relates. Management has a policy to abandon old titles before the end of their economic lives and replace them immediately with new titles for the same customer segment. What is the cash-generating unit for an individual magazine title?

Solution

It is likely that the recoverable amount of an individual magazine title can be assessed. Even though the level of advertising income for a title is influenced, to a certain extent, by the other titles in the customer segment, cash inflows from direct sales and advertising are identifiable for each title. In addition, although titles are managed by customer segments, decisions to abandon titles are made on an individual title basis. Therefore, it is likely that individual magazine titles generate cash inflows that are largely independent of each other and that each magazine title is a separate cash-generating unit.

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Illustration 17

A mining entity owns a private railway to support its mining activities. The private railway could be sold only for scrap value and it does not generate cash inflows that are largely independent of the cash inflows from the other assets of the mine. Should the entity determine the recoverable amount for the private railway or for the mining business as a whole?

Solution

It is not possible to estimate the recoverable amount of the private railway because its value in use cannot be determined and is probably different from scrap value. Therefore, the entity estimates the recoverable amount of the cash-generating unit to which the private railway belongs, i.e., the mine as a whole.

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Illustration 18

A bus company provides services under contract with a municipality that requires minimum service on each of seven separate routes. Assets devoted to each route and the cash flows from each route can be identified separately. One of the routes operates at a significant loss. Should the company determine the recoverable amount for an individual asset or for a cash generating unit?

Solution

Because the entity does not have the option to curtail any one bus route, the lowest level of identifiable cash inflows that are largely independent of the cash inflows from other assets or groups of assets is the cash inflows generated by the seven routes together. The cash- generating unit for each route is the bus company as a whole.

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Illustration 19

A significant raw material used for plant Y's final production is an intermediate product bought from plant X of the same entity. X's products are sold to Y at a transfer price that passes all margins to X. 80% of Y's final production is sold to customers outside of the entity.

60% of X's final production is sold to Y and the remaining 40% is sold to customers outside of the entity. For each of the following cases, what are the cash-generating units for X and Y?

(a) If X could sell the products it sells to Y in an active market and internal transfer prices are higher than market prices, what are the cash-generating units for X and Y?

(b) If there is no active market for the products X sells to Y, what are the cash-generating units for X and Y?

Solution

(a) **Cash-generating unit for X:** X could sell its products in an active market and, so, generate cash inflows that would be largely independent of the cash inflows from Y. Therefore, it is likely that X is a separate cash-generating unit, although part of its production is used by Y.

Cash-generating unit for Y: It is likely that Y is also a separate cash-generating unit. Y sells 80% of its products to customers outside of the entity. Therefore, its cash inflows can be regarded as largely independent.

Effect of internal transfer pricing: Internal transfer prices do not reflect market prices for X's output. Therefore, in determining value in use of both X and Y, the entity adjusts financial budgets/forecasts to reflect management's best estimate of future prices that could be achieved in arm's length transactions for those of X's products that are used internally.

(b) **Cash-generating units for X and Y:** It is likely that the recoverable amount of each plant cannot be assessed independently of the recoverable amount of the other plant because:

(i) the majority of X's production is used internally and could not be sold in an active market. So, cash inflows of X depend on demand for Y's products. Therefore, X cannot be considered to generate cash inflows that are largely independent of those of Y.

(ii) the two plants are managed together.

As a consequence, it is likely that X and Y together are the smallest group of assets that generates cash inflows that are largely independent.

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Illustration 20

XYZ Limited produces a single product and owns plants 1, 2 and 3. Each plant is located in a different country. Plant 1 produces a component that is assembled in either Plant 2 or Plant 3. The combined capacity of Plant 2 and Plant 3 is not fully utilised. XYZ Limited's products are sold worldwide from either Plant 2 or Plant 3, e.g., Plant 2's production can be sold in Plant 3's country if the products can be delivered faster from Plant 2 than from Plant 3. Utilisation levels of Plant 2 and Plant 3 depend on the allocation of sales between the two sites. If there is no active market for Plant 1's products, what are the cash-generating units for Plant 1, Plant 2 and Plant 3?

Solution

It is likely that the recoverable amount of each plant cannot be assessed independently because:

(a) There is no active market for Plant 1's products. Therefore, Plant 1's cash inflows depend on sales of the final product by Plant 2 and Plant 3.

(b) Although there is an active market for the products assembled by Plant 2 and Plant 3, cash inflows for Plant 2 and Plant 3 depend on the allocation of production across the two sites. It is unlikely that the future cash inflows for Plant 2 and Plant 3 can be determined individually.

As a consequence, it is likely that Plant 1, Plant 2 and Plant 3 together (i.e., XYZ Limited as a whole) are the smallest identifiable group of assets that generates cash inflows that are largely independent.

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Illustration 21

A company operates a mine in a country where legislation requires that the owner must restore the site on completion of its mining operations. The cost of restoration includes the replacement of the overburden, which must be removed before mining operations commence. A provision for the costs to replace the overburden was recognised as soon as the overburden was removed. The amount provided was recognised as part of the cost of the mine and is being depreciated over the mine's useful life. The carrying amount of the provision for restoration costs is ₹ 500, which is equal to the present value of the restoration costs.

The entity is testing the mine for impairment. The cash-generating unit for the mine is the mine as a whole. The entity has received various offers to buy the mine at a price of around ₹ 800. This price reflects the fact that the buyer will assume the obligation to restore the overburden. Disposal costs *for the mine are negligible. The value in use of the mine is approximately ₹ 1,200 excluding restoration costs. The carrying amount of the mine is ₹ 1,000.*

Is the mine required to be impaired?

Solution

The cash-generating unit's fair value *less* costs to sell is ₹ 800. This amount considers restoration costs that have already been provided for. As a consequence, the value in use for the cash-generating unit is determined after consideration of the restoration costs and is estimated to be ₹ 700 (₹ 1,200 *less* ₹ 500). The carrying amount of the cash-generating unit is ₹ 500, which is the carrying amount of the mine (₹ 1,000) *less* the carrying amount of the provision for restoration costs (₹ 500). Therefore, the recoverable amount of the cash-generating unit exceeds its carrying amount. Thus, there is no impairment loss.

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Illustration 22

An entity sells for ₹ 100 crore an operation that was part of a cash-generating unit to which goodwill has been allocated. The goodwill allocated to the unit cannot be identified or associated with an asset group at a level lower than that unit, except arbitrarily. The recoverable amount of the portion of the cash-generating unit retained is ₹ 300 crore. How the goodwill should be allocated to the operation sold?

Solution

Since goodwill allocated to the cash-generating unit cannot be non-arbitrarily identified or associated with an asset group at a level lower than that unit, the goodwill associated with the operation disposed of is measured on the basis of the relative values of the operation disposed of and the portion of the unit retained. Therefore, 25% of the goodwill allocated to the cash-generating unit is included in the carrying amount of the operation that is sold.

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Illustration 23

Goodwill had previously been allocated to cash-generating unit A. The goodwill allocated to A cannot be identified or associated with an asset group at a level lower than A, except arbitrarily. A is to be divided and integrated into three other cash-generating units, B, C and D. How the goodwill should be reallocated to B, C and D?

Solution

Since goodwill allocated to A cannot be non-arbitrarily identified or associated with an asset group at a level lower than A, it is reallocated to units B, C and D on the basis of the relative values of the three portions of A before those portions are integrated with B, C and D.

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Illustration 24

XYZ Limited has a cash-generating unit 'Plant A' as on 1st April, 20X1 having a carrying amount of ₹ 1,000 crore. Plant A was acquired under a business combination and goodwill of ₹ 200 crore was allocated to it. It is depreciated on straight line basis. Plant A has a useful life of 10 years with no residual value. On 31st March, 20X2, Plant A has a recoverable amount of ₹ 600 crore. Calculate the impairment loss on Plant A. Also, prescribe its allocation as per Ind AS 36.

Solution

Particulars	Goodwill (₹ in crore)	Identifiable assets (₹ in crore)	Total (₹ in crore)
Historical cost	200	1,000	1,200
Depreciation (20X1-20X2)	-	(100)	(100)
Carrying amount	200	900	1,100

Since, the recoverable amount is ₹ 600 crore, there is an impairment loss of ₹ 500 crore. The impairment loss of ₹ 500 crore should be allocated to goodwill first, and then to the other identifiable assets, i.e., ₹ 200 crore to goodwill and ₹ 300 crore to identifiable assets of Plant A.

			(₹ in crore)
Particulars	**Goodwill**	**Identifiable assets**	**Total**
Impairment loss	(200)	(300)	(500)
Carrying amount after impairment loss	-	600	600

*****

Illustration 25

Sun Ltd is an entity with various subsidiaries. The entity closes its books of account at every year ended on 31st March. On 1st July, 20X1, Sun Ltd acquired an 80% interest in Pluto Ltd. Details of the acquisition were as follows:

- *Sun ltd acquired 800,000 shares in Pluto Ltd by issuing two equity shares for every five acquired. The fair value of Sun Ltd's share on 1st July, 20X1 was ₹ 4 per share and the fair value of a Pluto's share was ₹ 1.40 per share. The costs of issue were 5% per share.*
- *Sun Ltd incurred further legal and professional costs of ₹ 100,000 that directly related to the acquisition.*
- *The fair values of the identifiable net assets of Pluto Ltd at 1st July, 20X1 were measured at ₹ 1.3 million. Sun Ltd initially measured the non-controlling interest in Pluto Ltd at fair value.*

They used the market value of a Pluto Ltd share for this purpose. No impairment of goodwill arising on the acquisition of Pluto Ltd was required at 31st March, 20X2 or 20X3.

Pluto Ltd comprises three cash generating units A, B and C. When Pluto Ltd was acquired the directors of Sun Ltd estimated that the goodwill arising on acquisition could reasonably be allocated to units A:B:C on a 2:2:1 basis. The carrying values of the assets in these cash generating units and their recoverable amounts are as follows:

Unit	Carrying value (before goodwill allocation)	Recoverable amount
	₹ '000	₹ '000
A	600	740
B	550	650
C	450	400

Required:

(i) Compute the carrying value of the goodwill arising on acquisition of Pluto Ltd in the consolidated Balance Sheet of Sun ltd at 31st March, 20X4 following the impairment review.

(ii) *Compute the total impairment loss arising as a result of the impairment review, identifying how much of this loss would be allocated to the non-controlling interests in Pluto ltd.*

Solution

1. Computation of goodwill on acquisition

Particular	Amount (₹ '000)
Cost of investment (8,00,000 x 2/5 x ₹ 4)	1,280
Fair value of non-controlling interest (2,00,000 x ₹ 1·4)	280
Fair value of identifiable net assets at date of acquisition	(1,300)
So goodwill equals	260

Acquisition costs are not included as part of the fair value of the consideration given under Ind AS 103, Business Combination.

2. Calculation of impairment loss

Unit	Carrying value			Recoverable Amount	Impairment Loss
	Before Allocation	Allocation of goodwill (2:2:1)	After Allocation		
A	600	104	704	740	Nil

B	550	104	654	650	4
C	400*	52	452	400	52

* After writing down assets in the individual CGU to recoverable amount.

3. Calculation of closing goodwill

Goodwill arising on acquisition (W1)	260
Impairment loss (W2)	(56)
So closing goodwill equals	204

4. Calculation of overall impairment loss

on goodwill (W3)	56
on assets in unit C (450 – 400)	50
So total loss equals	106

₹ 21.2 (20%) of the above is allocated to the NCI with the balance allocated to the shareholders of Sun ltd.

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5.12 SIGNIFICANT DIFFERENCES IN IND AS 36 *VIS-À-VIS* AS 28

S. No.	Particular	Ind AS 36	AS 28
1.	*Financial Assets*	Ind AS 36 applies to financial assets classified as subsidiaries, as defined in Ind AS 110, associates as defined in Ind AS 28, joint ventures as defined in Ind AS 111.	AS 28 does not apply to the above assets
2.	*Biological Assets:*	Ind AS 36 specifically excludes biological assets related to agricultural activity	AS 28 does not specifically exclude biological assets
3.	*Impairment Testing for an Intangible Asset with an Indefinite Useful Life*	Ind AS 36 requires annual impairment testing for an intangible asset with an indefinite useful life or not yet available for use and goodwill acquired in a business combination.	AS 28 does not require the annual impairment testing for the goodwill unless there is an indication of impairment.
4.	*Additional Guidance*	Ind AS 36 gives additional guidance on, *inter alia*, the following aspects:	AS 28 does not provide such guidance

		(a) estimating the value in use of an asset; (b) for managements to assess the reasonableness of the assumptions on which cash flows are based; and (c) using present value techniques in measuring an asset's value in use.	
5.	*Reversal of Goodwill*	Ind AS 36 prohibits the recognition of reversals of impairment loss for goodwill.	AS 28 requires that the impairment loss recognised for goodwill should be reversed in a subsequent period when it was caused by a specific external event of an exceptional nature that is not expected to recur and subsequent external events that have occurred that reverse the effect of that event
6.	*Bottom up and Top Down Test*	In Ind AS 36, goodwill is allocated to cash-generating units (CGUs) or groups of CGUs that are expected to benefit from the synergies of the business combination from which it arose. There is no bottom-up or top-down approach for allocation of goodwill	AS 28, goodwill is allocated to CGUs only when the allocation can be done on a reasonable and consistent basis. If that requirement is not met for a specific CGU under review, the smallest CGU to which the carrying amount of goodwill can be allocated on a reasonable and consistent basis must be identified and the impairment test carried out at this level. Thus, when all or a portion of goodwill cannot be allocated reasonably and consistently to the CGU being tested for impairment, two levels of impairment tests are carried out, viz., bottom-up test and top-down test.

TEST YOUR KNOWLEDGE

Questions

1. Apex Ltd. is engaged in manufacturing of steel utensils. It owns a building for its headquarters. The building used to be fully occupied for internal use. However, recently the company has undertaken a massive downsizing exercise as a result of which 1/3rd of the building became vacant. This vacant portion has now been given for on lease for 6 years. Determine the CGU of the building.

2. ABC Ltd. has three cash-generating units: A, B and C, the carrying amounts of which as on 31st March, 20X1 are as follows:

		(₹ in crore)
Cash-generating units	**Carrying amount**	**Remaining useful life**
A	500	10
B	750	20
C	1,100	20

ABC Ltd. also has two corporate assets having a remaining useful life of 20 years.

		(₹ in crore)
Corporate asset	**Carrying amount**	**Remarks**
X	600	The carrying amount of X can be allocated on a reasonable basis (i.e., pro rata basis) to the individual cash-generating units.
Y	200	The carrying amount of Y cannot be allocated on a reasonable basis to the individual cash-generating units.

Recoverable amount as on 31st March, 20X1 is as follows:

Cash-generating units	Recoverable amount (₹ in crore)
A	600
B	900
C	1,400
ABC Ltd.	3,200

Calculate the impairment loss, if any. Ignore decimals.

3. Parent acquires an 80% ownership interest in Subsidiary for ₹ 2,100 on 1st April, 20X1. At that date, Subsidiary's net identifiable assets have a fair value of ₹ 1,500. Parent chooses to measure the non-controlling interests as the proportionate interest of Subsidiary's net

identifiable assets. The assets of Subsidiary together are the smallest group of assets that generate cash inflows that are largely independent of the cash inflows from other assets or groups of assets. Since other cash-generating units of Parent are expected to benefit from the synergies of the combination, the goodwill of ₹ 500 related to those synergies has been allocated to other cash-generating units within Parent. On 31st March, 20X2, Parent determines that the recoverable amount of cash-generating unit Subsidiary is ₹ 1,000. The carrying amount of the net assets of Subsidiary, excluding goodwill, is ₹ 1,350. Allocate the impairment loss on 31st March, 20X2.

4. A Ltd. purchased a machinery of ₹ 100 crore on 1st April, 20X1. The machinery has a useful life of 5 years. It has nil residual value. A Ltd. adopts straight line method of depreciation for depreciating the machinery. Following information has been provided as on 31st March, 20X2:

Financial year	Estimated future cash flows (₹ in crore)
20X2-20X3	15
20X3-20X4	30
20X4-20X5	40
20X5-20X6	10

Discount rate applicable : 10%

Fair value less costs to sell as on 31st March, 20X2 : ₹ 70 crore

Calculate the impairment loss, if any.

5. Assuming in the above question, as on 31st March, 20X3, there is no change in the estimated future cash flows and discount rate. Fair value less costs to sell as on 31st March, 20X3 is ₹ 40 crore. How should it be dealt with under Ind AS 36?

Financial year	Estimated cash flows (₹ in crore)	Present value factor @ 10%	Present value
20X3-20X4	30	0.9091	27.27
20X4-20X5	40	0.8264	33.06
20X5-20X6	10	0.7513	7.51
			67.84

6. A Ltd. purchased an asset of ₹ 100 lakh on 1st April, 20X0. It has useful life of 4 years with no residual value. Recoverable amount of the asset is as follows:

As on	Recoverable amount
31st March, 20X1	₹ 60 lakh
31st March, 20X2	₹ 40 lakh
31st March, 20X3	₹ 28 lakh

Calculate the amount of impairment loss or its reversal, if any, on 31st March, 20X1, 31st March, 20X2 and 31st March, 20X3.

7. On 31st March, 20X1, XYZ Ltd. makes following estimate of cash flows for one of its asset located in USA:

Year	Cash flows
20X1-20X2	US $ 80
20X2-20X3	US $ 100
20X3-20X4	US $ 20

Following information has been provided:

Particulars	India	USA
Applicable discount rate	15%	10%

Exchange rates are as follows:

As on	Exchange rate
31st March, 20X1	₹ 45/US $

As on	Expected Exchange rate
31st March, 20X2	₹ 48/US $
31st March, 20X3	₹ 51/US $
31st March, 20X4	₹ 55/US $

Calculate value in use as on 31st March, 20X1.

8. Cash flow is ₹ 100, ₹ 200 or ₹ 300 with probabilities of 10%, 60% and 30%, respectively. Calculate expected cash flows.

9. Cash flow of ₹ 1,000 may be received in one year, two years or three years with probabilities of 10%, 60% and 30%, respectively. Calculate expected cash flows assuming applicable discount rate of 5%, 5.25% and 5.5% in year 1, 2 and 3, respectively.

10. Calculate expected cash flows in each of the following cases:

(a) the estimated amount falls somewhere between ₹ 50 and ₹ 250, but no amount in the range is more likely than any other amount.

(b) the estimated amount falls somewhere between ₹ 50 and ₹ 250, and the most likely amount is ₹ 100. However, the probabilities attached to each amount are unknown.

(c) the estimated amount will be ₹ 50 (10 per cent probability), ₹ 250 (30 per cent probability), or ₹ 100 (60 per cent probability).

Answers

1. CGU of the building is Apex Ltd. as a whole as the primary purpose of the building is to serve as a corporate asset.

2. **Allocation of corporate assets**

The carrying amount of X is allocated to the carrying amount of each individual cash- generating unit. A weighted allocation basis is used because the estimated remaining useful life of A's cash-generating unit is 10 years, whereas the estimated remaining useful lives of B and C's cash-generating units are 20 years.

(₹ in crore)

Particulars	A	B	C	Total
Carrying amount	500	750	1,100	2,350
Useful life	10 years	20 years	20 years	—
Weight based on useful life	1	2	2	—
Carrying amount (after assigning weight)	500	1,500	2,200	4,200
Pro-rata allocation of X	12% (500/4,200)	36% (1,500/4,200)	52% (2,200/4,200)	100%
Allocation of carrying amount of X	72	216	312	600
Carrying amount (after allocation of X)	572	966	1,412	2,950

Calculation of impairment loss

Step I: Impairment losses for individual cash-generating units and its allocation

(a) Impairment loss of each cash-generating units

(₹ in crore)

Particulars	A	B	C
Carrying amount (after allocation of X)	572	966	1,412
Recoverable amount			
Impairment loss	600	900	1400
	-	66	12

(b) Allocation of the impairment loss

(₹ in crore)

Allocation to	B		C	
X	15	(66 x 216/966)	3	(12 x 312/1,412)
Other assets in cash-generating units	51	(66 x 750/ 966)	9	(12 x 1,100/ 1,412)
Impairment loss	66		12	

Step II: Impairment losses for the larger cash-generating unit, i.e., ABC Ltd. as a whole

						(₹ in crore)
Particulars	**A**	**B**	**C**	**X**	**Y**	**ABC Ltd.**
Carrying amount	500	750	1,100	600	200	3,150
Impairment loss (Step I)	-	(51)	(9)	(18)	-	(78)
Carrying amount (after Step I)	500	699	1,091	582	200	3,072
Recoverable amount						3,200
Impairment loss for the 'larger' cash-generating unit						Nil

3. Non-controlling interests is measured as the proportionate interest of Subsidiary's net identifiable assets, i.e., ₹ 300 (20% of ₹ 1,500). Goodwill is the difference between the aggregate of the consideration transferred and the amount of the non-controlling interests (₹ 2,100 + ₹ 300) and the net identifiable assets (₹ 1,500), i.e., ₹ 900.

Since, the assets of Subsidiary together are the smallest group of assets that generate cash inflows that are largely independent of the cash inflows from other assets or groups of assets, therefore, Subsidiary is a cash-generating unit. Since other cash-generating units of Parent are expected to benefit from the synergies of the combination, the goodwill of ₹ 500 related to those synergies has been allocated to other cash-generating units within Parent. Because the cash-generating unit comprising Subsidiary includes goodwill within its carrying amount, it should be tested for impairment annually, or more frequently if there is an indication that it may be impaired.

Testing Subsidiary (cash-generating unit) for impairment

Goodwill attributable to non-controlling interests is included in Subsidiary's recoverable amount of ₹ 1,000 but has not been recognised in Parent's consolidated financial statements. Therefore, the carrying amount of Subsidiary should be grossed up to include goodwill attributable to the non-controlling interests, before being compared with the recoverable amount of ₹ 1,000. Goodwill attributable to Parent's 80% interest in Subsidiary at the acquisition date is ₹ 400 after allocating ₹ 500 to other cash-generating units within Parent. Therefore, goodwill attributable to the 20% non-controlling interests in Subsidiary at the acquisition date is ₹ 100.

Testing subsidiary for impairment on 31st March, 20X2

On 31st March, 20X2	Goodwill of subsidiary (₹)	Net identifiable assets (₹)	Total (₹)
Carrying amount	400	1,350	1,750
Unrecognised non-controlling interests	100	-	100

Adjusted carrying amount	**500**	**1,350**	**1,850**
Recoverable amount			1,000
Impairment loss			**850**

Allocating the impairment loss

The impairment loss of ₹ 850 should be allocated to the assets in the unit by first reducing the carrying amount of goodwill.

Therefore, ₹ 500 of the ₹ 850 impairment loss for the unit is allocated to the goodwill. If the partially-owned subsidiary is itself a cash-generating unit, the goodwill impairment loss should be allocated to the controlling and non-controlling interests on the same basis as that on which profit or loss is allocated. In this case, profit or loss is allocated on the basis of relative ownership interests. Because the goodwill is recognised only to the extent of Parent's 80% ownership interest in Subsidiary, Parent recognises only 80% of that goodwill impairment loss (i.e., ₹ 400).

The remaining impairment loss of ₹ 350 is recognised by reducing the carrying amounts of Subsidiary's identifiable assets.

Allocation of the impairment loss for Subsidiary on 31st March, 20X2

On 31st March, 20X2	Goodwill of subsidiary (₹)	Net identifiable assets (₹)	Total (₹)
Carrying amount	400	1,350	1,750
Impairment loss	(400)	(350)	(750)
Carrying amount after impairment loss	**-**	**1,000**	**1,000**

4. Value in use of the machinery as on 31st March, 20X2 can be calculated as follows:

Financial year	Estimated cash flows (₹ in crore)	Present value factor @ 10%	Present value
20X2-20X3	15	0.9091	13.64
20X3-20X4	30	0.8264	24.79
20X4-20X5	40	0.7513	30.05
20X5-20X6	10	0.6830	6.83
			75.31

The recoverable amount of the machinery is ₹ 75.31 crore (higher of value in use of ₹ 75.31 crore and fair value *less* costs to sell of ₹ 70 crore). Carrying amount of the machinery is ₹ 80 crore (after providing for one year depreciation @ ₹ 20 crore). Therefore, the impairment loss of ₹ 4.69 crore should be provided in the books.

5. The recoverable amount of the machinery is ₹ 67.84 crore (higher of value in use of ₹ 67.84 crore and fair value *less* costs to sell of ₹ 40 crore). Carrying amount of the machinery at the end of the year 20X2 is ₹ 56.48 crore (after providing for two years depreciation (100-20-4.69)-18.83).

However, as per paragraph 116 of Ind AS 36, an impairment loss is not reversed just because of the passage of time (sometimes called the 'unwinding' of the discount), even if the recoverable amount of the asset becomes higher than its carrying amount.

Therefore, the impairment loss of ₹ 4.69 crore should not be reversed.

6. **As on 31st March, 20X1**

Carrying amount of the asset (opening balance)	₹ 100 lakh
Depreciation (₹ 100 lakh /4 years)	₹ 25 lakh
Carrying amount of the asset (closing balance)	₹ 75 lakh
Recoverable amount (given)	₹ 60 lakh

Therefore, an impairment loss of ₹ 15 lakh should be recognised as on 31st March, 20X1. Depreciation for subsequent years should be charged on the carrying amount of the asset (after providing for impairment loss), i.e., ₹ 60 lakh.

As on 31st March, 20X2

Carrying amount of the asset (opening balance)	₹ 60 lakh
Depreciation (₹ 60 lakh /3 years)	₹ 20 lakh
Carrying amount of the asset (closing balance)	₹ 40 lakh

Therefore, no impairment loss should be recognised as on 31st March, 20X2.

As on 31st March, 20X3

Carrying amount of the asset (opening balance)	₹ 40 lakh
Depreciation (₹ 40 lakh / 2 years)	₹ 20 lakh
Carrying amount of the asset (closing balance)	₹ 20 lakh
Recoverable amount (given)	₹ 28 lakh

Since, the recoverable amount of the asset exceeds the carrying amount of the asset by ₹ 8 lakh, impairment loss recognised earlier should be reversed. However, reversal of an impairment loss should not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years.

Carrying amount as on 31st March, 20X3 had no impairment loss being recognised would have been ₹ 25 lakh. Therefore, the reversal of an impairment loss of ₹ 5 lakh should be done as on 31st March, 20X3.

7.

Year	Cash flows (US $)	Present value factor @ 10%	Discounted cash flows (US $)
20X1-20X2	80	0.9091	72.73
20X2-20X3	100	0.8264	82.64
20X3-20X4	20	0.7513	15.03
Total Discounted cash flows in US $			170.40
Exchange rate as on 31st March, 20X1, i.e., date of calculating value in use ₹ 45/US $			
Value in use as on 31st March, 20X1			₹ 7,668

8.

Cash flow	Probability	Expected cash flow
100	10%	10
200	60%	120
300	30%	90
Total		220

The expected cash flow is ₹ 220.

9.

Years	Cash flow	P.V.F.	Present value	Probability	Expected cash flow
1	1,000	0.95238	952.38	10%	95.24
2	1,000	0.90273	902.73	60%	541.64
3	1,000	0.85161	851.61	30%	255.48
Total					892.36

The expected present value is ₹ 892.36.

10. (a) the estimated expected cash flow is ₹ 150 [(50 + 250)/2].

(b) the estimated expected cash flow is ₹ 133.33 [(50 + 100 + 250)/3].

(c) the estimated expected cash flow is ₹ 140 [(50 × 0.10) + (250 × 0.30) + (100 × 0.60)].

UNIT 6 : INDIAN ACCOUNTING STANDARD 38 : INTANGIBLE ASSETS

LEARNING OUTCOMES

After studying this unit, you will be able to

- Understand the Scope and Meaning of Intangible Asset
- Recognise the criteria
- Measure the intangible assets at Initial Recognition
- Examine the Mode of Acquisition
- Measure the intangible assets after Recognition
- Evaluate Amortisation and useful life of Intangible Asset
- De-Recognition and comply with the Disclosure requirements of the standard.

UNIT OVERVIEW

Objective

Prescribe the accounting treatment for Intangible Assets which are not dealt in another standard

Scope exclusion:

- Intangible assets covered by another Standards
- Financial Assets
- Exploration and evaluation assets
- Mineral rights and mineral reserves

Meaning of Intangible Asset

- Identifiable
- Non-monetary asset
- Without physical substance

Measurement of Intangible Asset:

Intial Measurement : At Cost

Subsequent Measurement : Cost or Revaluation Model

Intangible Asset may arise from:

Separate Acquisition
Part of a Business combination
Government Grant
Internally generated goodwill
Internally generated intangible assets
Exchange of assets

Amortisation of I.A. with finite useful life.

I.A. with indefinite usseful lives review for annual impairment

6.1 OBJECTIVE

The objective of this Standard is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Standard. This Standard requires an entity to recognise an intangible asset if, and only if, specified criteria are met. This standard specifies the requirement of recognition, measurement and disclosures of Intangible Assets.

The Standard states that intangible assets are initially measured at cost, subsequently measured at cost or using the revaluation model, and amortised on a systematic basis over their useful lives unless the asset has an indefinite useful life, in which case it is not amortised.

6.2 SCOPE

6.2.1 Applicability

This Standard shall be applied to all intangible assets, except:

(a) intangible assets that are within the scope of another Standard, for example:

- Intangible assets held for sale in ordinary course of business (Ind AS 2)
- Deferred tax assets (Ind AS 12)
- Leases of intangibles assets (Ind AS 116)
- Assets arising from employee benefits (Ind AS 19)
- Financial assets (Ind AS 32)
- Goodwill arising in a business combination (Ind AS 103)
- Deferred acquisition costs and intangible assets arising from insurance contract (Ind AS 104)
- Non Current intangible assets classified as held for sale (Ind AS 105)
- Assets arising from contracts with customers (Ind AS 115)

(b) financial assets, as defined in Ind AS 32, *Financial Instruments: Presentation*;

(c) the recognition and measurement of exploration and evaluation assets (see Ind AS 106, *Exploration for and Evaluation of Mineral Resources*); and

(d) expenditure on the development and extraction of minerals, oil, natural gas and similar non-regenerative resources.

6.2.2 Intangible assets contained in or on a physical substance

Some intangible assets may be contained in or on a physical substance such as a compact disc (in the case of computer software), legal documentation (in the case of a licence or patent) or film. In determining whether an asset that incorporates both tangible and intangible elements should be treated under Ind AS 16, Property, Plant and Equipment, or as an intangible asset under this Standard, an entity uses judgement to assess which element is more significant.

> For example, computer software for a computer-controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as property, plant and equipment. The same applies to the operating system of a computer. When the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

Research and development activities are directed to the development of knowledge. Therefore, although these activities may result in an asset with physical substance (eg a prototype), the physical element of the asset is secondary to its intangible component, ie the knowledge embodied in it.

6.2.3 Intangible assets on leases

Rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights are excluded from the scope of Ind AS 116, and are within the scope of this Standard.

6.2.4 Intangible assets used in the extractive and insurance industries

This Standard does not apply to expenditure on the exploration for, or development and extraction of, oil, gas and mineral deposits in extractive industries and in the case of insurance contracts. However, this Standard applies to other intangible assets used (such as computer software), and other expenditure incurred (such as start-up costs), in extractive industries or by insurers.

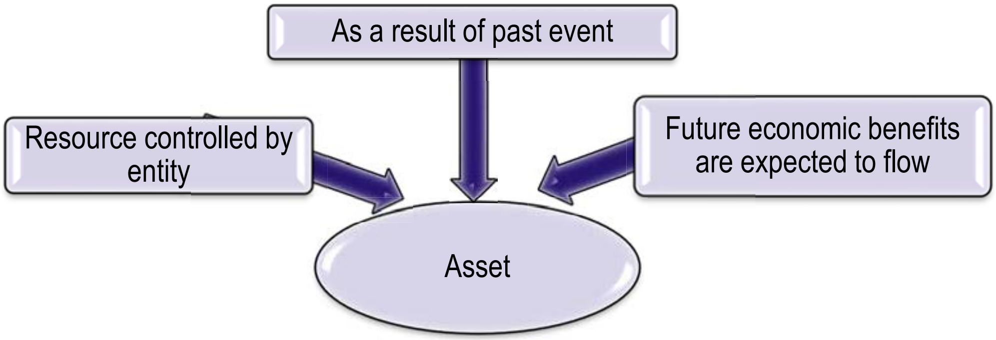
6.2.5 Amortisation method specified in this standard not to apply to intangible assets arising from service concession arrangements in respect of toll roads

The amortisation method specified in this Standard does not apply to an entity that opts to amortise the intangible assets arising from service concession arrangements in respect of toll roads recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS reporting period as per the optional exemption given in Ind AS 101, First time adoption of Indian Accounting Standards.

6.3 RELEVANT DEFINITIONS

The following are the key terms used in this standard:

- **Amortisation** is the systematic allocation of the depreciable amount of an intangible asset over its useful life.
- An **asset** is a resource:



(a) controlled by an entity as a result of past events; and

(b) from which future economic benefits are expected to flow to the entity.

- **Carrying amount** is the amount at which an asset is recognised in the balance sheet after deducting any accumulated amortisation and accumulated impairment losses thereon.
- **Cost** is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction, or, when applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other Indian Accounting Standards, for e.g Ind AS 102, *Share-based Payment*.
- **Depreciable amount** is the cost of an asset, or other amount substituted for cost, less its residual value.
- **Development** is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.
- **Entity-specific value** is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability.
- **Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See Ind AS 113, *Fair Value Measurement.*)

- An **impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount.
- An **intangible asset** is an identifiable non-monetary asset without physical substance.
- **Monetary assets** are money held and assets to be received in fixed or determinable amounts of money.
- **Research** is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.
- The **residual value** of an intangible asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.
- **Useful life** is:

  (a) the period over which an asset is expected to be available for use by an entity; or

  (b) the number of production or similar units expected to be obtained from the asset by an entity.

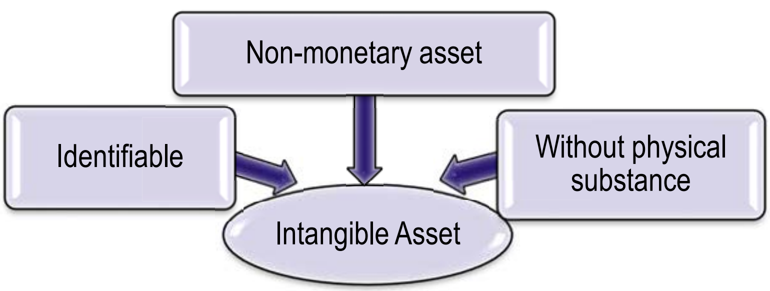
6.4 IDENTIFICATION OF INTANGIBLE ASSETS

6.4.1 Meaning of Intangible asset

An intangible asset is an identifiable non-monetary asset without physical substance. The key components of this definition are:

(i) Identifiability; and

(ii) Asset



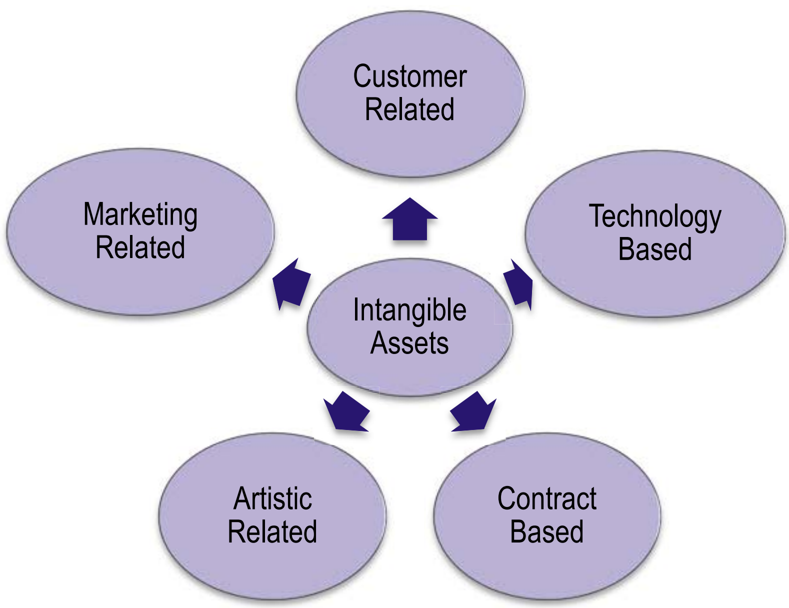
Entities frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as:

- Scientific or technical knowledge
- Design and implementation of new processes or systems

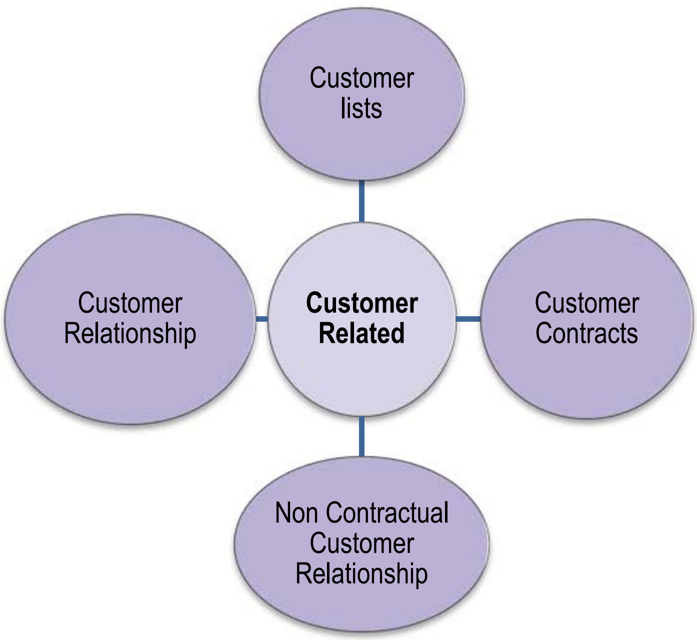
- Licences
- Intellectual property
- Market knowledge and trademarks (including brand names and publishing titles).

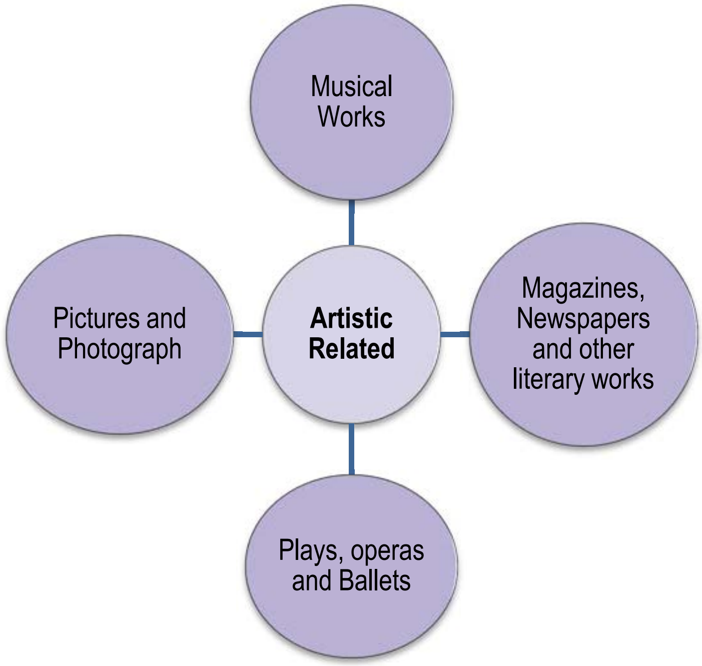
Common examples of items encompassed by these broad headings are:

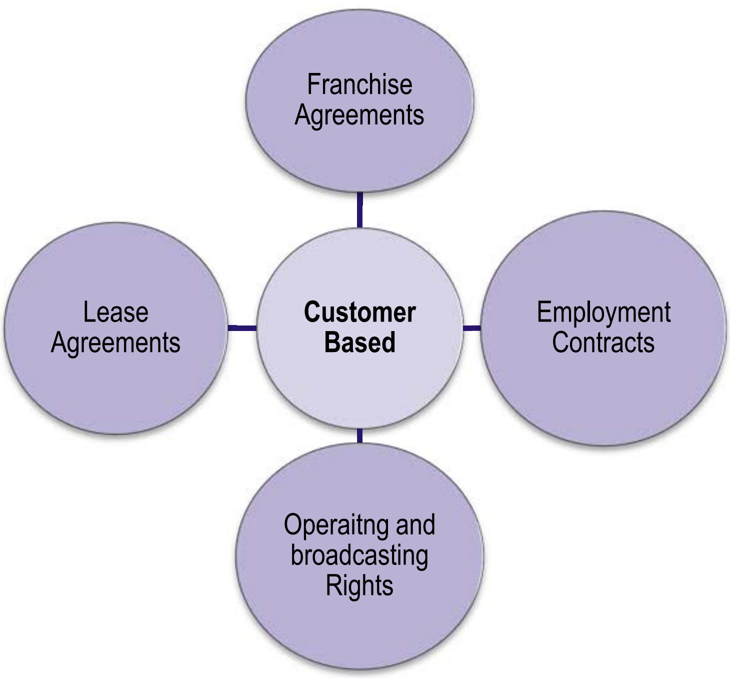
- Computer software
- Patents
- Copyrights
- Motion picture films
- Customer lists
- Mortgage servicing rights
- Fishing licences
- Import quotas
- Franchises
- Customer or supplier relationships
- Customer loyalty
- Market share and marketing rights.

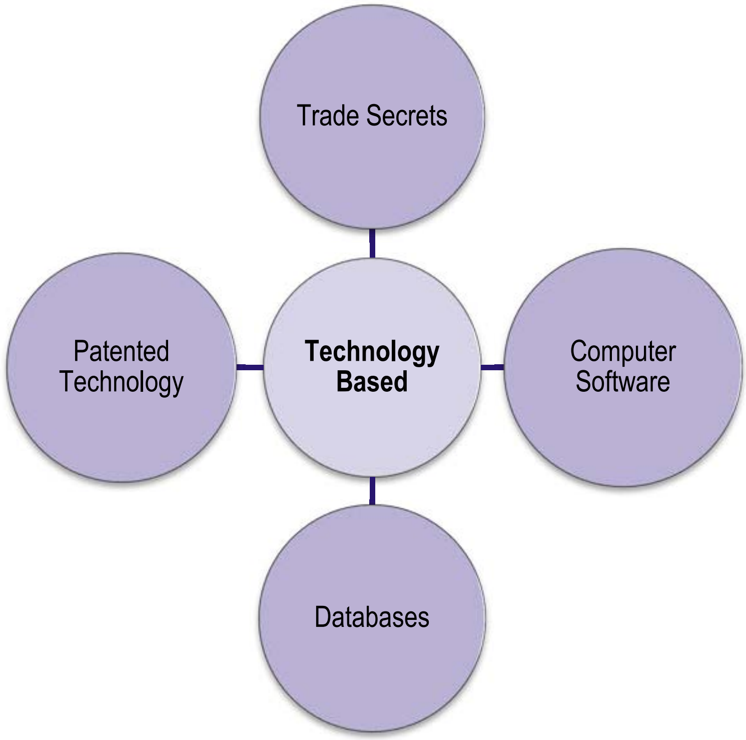


Let's run through some examples of each broad category listed above :




Musical Works
Pictures and Photograph
Artistic Related
Magazines, Newspapers and other literary works
Plays, operas and Ballets


Franchise Agreements
Lease Agreements
Customer Based
Employment Contracts
Operaitng and broadcasting Rights



Not necessarily all of the above item meet the conditions of recognizing as an Intangible Assets within purview of this standard:

- Identifiability
- Control over a Resource (Asset) and
- Existence of Future Economic Benefits.

Note: If an item within the scope of this Standard does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in a business combination, it forms part of the goodwill recognised at the acquisition date.

Let us understand each concept one by one.

6.4.2 Identifiability

The definition of an intangible asset requires an intangible asset to be identifiable to distinguish it from goodwill. Goodwill recognised in a business combination is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised. The future economic benefits may result from synergy between the identifiable assets acquired or from assets that, individually, do not qualify for recognition in the financial statements.

An asset is identifiable if it either:

(a) is separable, ie is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Illustration 1: Identifiability

Sun Ltd has an expertise in consulting business. In past years, company has gained a market share for its services of 30 percent and considers recognising it as an intangible asset. Is the action by company is justified?

Solution

Market share does not meet the definition of intangible assets as is not identifiable i.e. It is neither separable and nor arised from contractual or legal rights.

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6.4.3 Asset

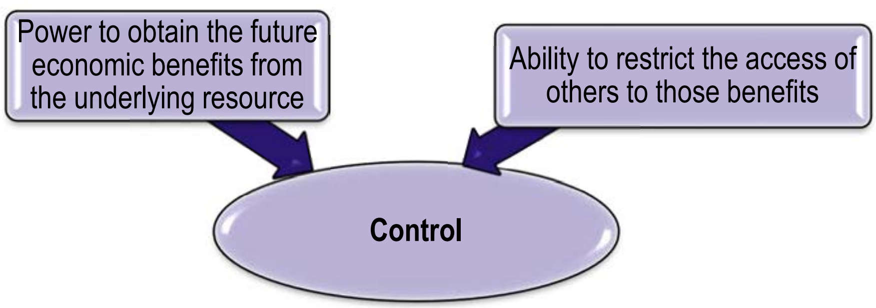
An asset is a resource:

(a) controlled by an entity as a result of past events; and

(b) from which future economic benefits are expected to flow to the entity.

6.4.3.1 Control

An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. The capacity of an entity to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law.



In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control because an entity may be able to control the future economic benefits in some other way.

Market and technical knowledge may give rise to future economic benefits. An entity controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement (where permitted) or by a legal duty on employees to maintain confidentiality.

Example:

An entity may have a team of skilled staff and may be able to identify incremental staff skills leading to future economic benefits from training. The entity may also expect that the staff will continue to make their skills available to the entity. However, an entity usually has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training for these items to meet the definition of an intangible asset.

For a similar reason, specific management or technical talent is unlikely to meet the definition of an intangible asset, unless it is protected by legal rights to use it and to obtain the future economic benefits expected from it, and it also meets the other parts of the definition.

An entity may have a portfolio of customers or a market share and expect that, because of its efforts in building customer relationships and loyalty, the customers will continue to trade with the entity. However, in the absence of legal rights to protect, or other ways to control, the relationships with customers or the loyalty of the customers to the entity, the entity usually has insufficient control over the expected economic benefits from customer relationships and loyalty for such items (e.g. portfolio of customers, market shares, customer relationships and customer loyalty) to meet the definition of intangible assets. In the absence of legal rights to protect customer relationships, exchange transactions for the same or similar non-contractual customer relationships (other than as part of a business combination) provide evidence that the entity is nonetheless able to control the expected future economic benefits flowing from the customer relationships. Because such exchange transactions also provide evidence that the customer relationships are separable, those customer relationships meet the definition of an intangible asset.

Illustration 2 : Control

Company XYZ ltd has provided training to its staff on various new topics like GST, Ind AS etc. to ensure the compliance as per the required law. Can the company recognise such cost of staff training as intangible asset?

Solution

It is clear that the company will obtain the economic benefits from the work performed by the staff as it increases their efficiency. But it does not have control over them because staff could choose to resign the company at any time.

Hence the company lacks the ability to restrict the access of others to those benefits. Therefore, the staff training cost does not meet the definition of an intangible asset.

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6.4.3.2 Future economic benefits

The future economic benefits flowing from an intangible asset may include:

(a) Revenue from the sale of products or services;

(b) Cost savings; or

(c) Other benefits resulting from the use of the asset by the entity.

For example: The use of intellectual property in a production process may reduce future production costs rather than increase future revenues.

Illustration 3: Identifiability of Intangible assets

Pluto Ltd. intends to open a new retail store in a new location in the next few weeks. Pluto Ltd has spent a substantial sum on a series of television advertisements to promote this new store. The Company has paid an amount of ₹ 800,000 for advertisements before 31st March, 20X1. ₹ 700,000 of this sum relates to advertisements shown before 31st March, 20X1 and ₹ 100,000 to advertisements shown in April, 20X1. Since 31st March, 20X1. The Company has paid for further advertisements costing ₹ 400,000.

Pluto Ltd is of view that such costs can be carried forward as intangible assets. Since market research indicates that this new store is likely to be highly successful. Please explain and justify the treatment of the above costs in the financial statements for the year ended 31st March, 20X1.

Solution

Under Ind AS 38 – *Intangible Assets* – intangible assets can only be recognised if they are **identifiable** and have a **cost** which can be reliably measured.

These criteria are very difficult to satisfy for internally developed intangibles.

For these reasons, Ind AS 38 specifically prohibits recognising advertising expenditure as an intangible asset. The issue of how successful the store is likely to be does not affect this prohibition. Therefore, such costs should be recognised as expenses.

However, the costs would be recognised on an accruals basis. Therefore, of the advertisements paid for before 31st March, 20X1, ₹ 7,00,000 would be recognised as an expense and ₹ 1,00,000 as a pre-payment in the year ended 31st March, 20X1. The ₹ 4,00,000 cost of advertisements paid for since 31st March, 20X1 would be charged as expenses in the year ended 31st March, 20X2.

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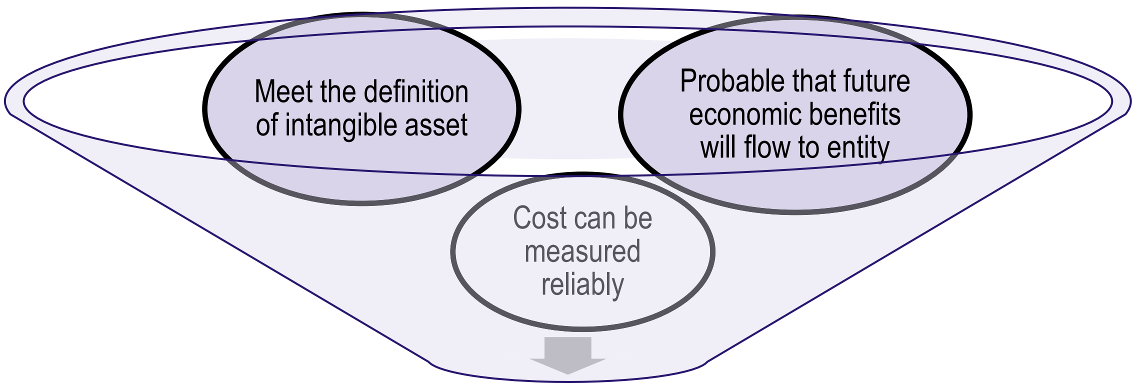
6.5 RECOGNITION OF INTANGIBLE ASSET

6.5.1 Recognition of Intangible assets – general principles

Provided that an item meets the definition of an intangible asset, it should be recognised in the financial statements if, and only if:

(a) it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and

(b) the cost of the asset can be measured reliably.



Intangible Asset -Recognition Criteria

- **This requirement applies to:**

  (a) costs incurred initially to acquire or internally generate an intangible asset; and

  (b) those incurred subsequently to add to, replace part of, or service it.

- An entity should assess the probability of expected future economic benefits using reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset.

- The nature of intangible assets is such that, in many cases, there are no additions to such an asset or replacements of part of it. Accordingly, most subsequent expenditures are likely to maintain the expected future economic benefits embodied in an existing intangible asset rather than meet the definition of an intangible asset and the recognition criteria in this Standard.

- In addition, it is often difficult to attribute subsequent expenditure directly to a particular intangible asset rather than to the business as a whole. Therefore, only rarely will subsequent expenditure — expenditure incurred after the initial recognition of an acquired intangible asset or after completion of an internally generated intangible asset — be recognised in the carrying amount of an asset.

- Subsequent expenditure on brands, mastheads, publishing titles, customer lists and items similar in substance (whether externally acquired or internally generated) is always recognised in profit or loss as incurred. This is because such expenditure cannot be distinguished from expenditure to develop the business as a whole.

Illustration 4

Mercury Ltd is preparing its accounts for the year ended 31st March, 20X2 and is unsure about how to treat the following items.

1. *The company completed a grand marketing and advertising campaign costing ₹ 4.8 lakh. The finance director had authorised this campaign on the basis that it would create ₹ 8 lakh of additional profits over the next three years.*

2. *A new product was developed during the year. The expenditure totalled ₹ 3 lakh of which ₹ 1.5 lakh was incurred prior to 30th September, 20X1, the date on which it became clear that the product was technically viable. The new product will be launched in the next four months and its recoverable amount is estimated at ₹ 1.4 lakh.*

3. *Staff participated in a training programme which cost the company ₹ 5 lakh. The training organisation had made a presentation to the directors of the company outlining that incremental profits to the business over the next twelve months would be ₹ 7 lakh.*

What amounts should appear as intangible assets in accordance with Ind AS 38 and Ind AS 36 in Mercury's balance sheet as on 31st March, 20X2?

Solution

The treatment in Mercury's financials as at 31st March, 20X2 will be as follows:

1. **Marketing and advertising campaign:** No intangible asset will be recognised, because it is not possible to identify future economic benefits that are attributable only due to this campaign. All of the expenditure should be expensed in the statement of profit and loss.

2. **New product:** Development expenditure appearing in the balance sheet will be valued at ₹ 1.5 lakh as per Ind AS 38. The expenditure prior to the date on which the product becomes technically feasible is recognised in the statement of profit and loss. However, its recoverable amount is also given in the question. Therefore, applying provisions of Ind AS 36, the revised carrying amount on 31st March, 20X2 after impairment will be ₹ 1.4 lakh.

3. **Training programme:** No asset will be recognised, because there is no control of the company over the staff and when staff leaves the benefits of the training, whatever they may be, also departs.

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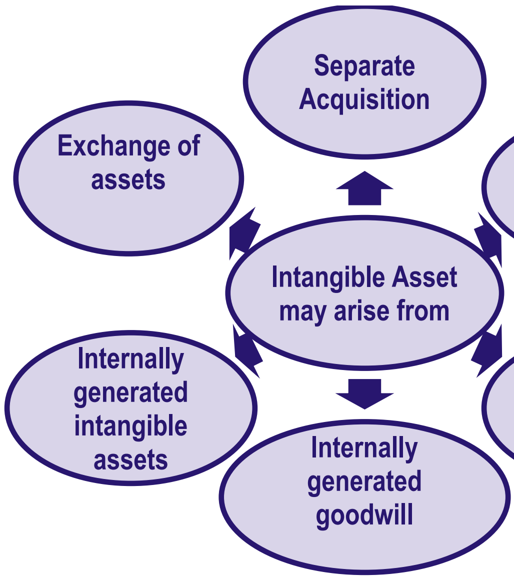
6.6 MEASUREMENT OF INTANGIBLE ASSET

An intangible asset should be measured initially at cost.

Intangible assets may be acquired or can be self generated. The below diagram reflect the method and mode by which Intangible assets may arise:



6.6.1 Separate acquisition

6.6.1.1 Recognition criteria for intangible assets acquired separately

Generally, the price an entity pays to acquire separately an intangible asset will reflect expectations about the probability that the expected future economic benefits associated with asset will flow to the entity. In other words, the entity expects there to be an inflow of economic benefits, even if there is uncertainty about the timing or the amount of the inflow.

Therefore, the probability recognition criterion specified above is always considered to be satisfied for separately acquired intangible assets.

In addition, the cost of a separately acquired intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

6.6.1.2 Measurement of cost for intangible assets acquired separately

The cost of a separately acquired intangible asset comprises:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and

(b) any directly attributable cost of preparing the asset for its intended use.

Cost includes

- Purchase price including import duties and non - refundable purchase taxes
- Directly attributable Cost of preparing the asset for its intended use. (Cost of Employee Benefits, Professional and Legal Fees Cost of Testing)

Examples of directly attributable costs are:

- Employee benefits cost (as defined in Ind AS 19) arising directly from bringing the asset to its working condition
- Professional Fees arising directly from bringing the asset to its working condition
- Costs of testing - whether the asset is working properly.

Examples of expenditures that are not part of the cost of an intangible asset are:

- Costs of introducing a new product or service (including cost of advertising and promotional activities)
- Costs of conducting business in a new location or with a new class of customer (including costs of staff training)
- Administrative and other general overhead costs

Deferred Consideration

If payment for an intangible asset is deferred beyond normal credit terms, then cost of such Intangible asset is the cash price equivalent. The difference between this amount and the total payments is recognised as interest expense over the period of credit unless it is capitalised in accordance with Ind AS 23, Borrowing Costs.

Cessation of capitalisation

Recognition of costs in the carrying amount of an intangible asset ceases when the asset is in the condition necessary for it to be capable of operating in the manner intended by management.

For example, the following costs are not included in the carrying amount of an intangible asset:

(a) costs incurred in using or redeploying an intangible asset;

(b) costs incurred while an asset capable of operating in the manner intended by management has yet to be brought into use; and

(c) initial operating losses, such as those incurred while demand for the asset's output builds up.

Example: Separate Acquisition

Jupiter Ltd acquires new energy efficient technology that will significantly reduce its energy costs for manufacturing.

	Costs incurred include	Cost to be capitalised as per Ind AS 38
Cost of new solar technology	10,00,000	10,00,000
Trade discount provided	(1,00,000)	(1,00,000)
Training course for staff in new technology	50,000	-
Initial testing of new technology	35,000	35,000
Losses incurred while other parts of plant shut down during testing and training	25,000	-
Total	**10,10,000**	**9,35,000**

Illustration 5: Separate Acquisition

Venus India Private Ltd acquired a software for its internal use costing ₹ 10,00,000. The amount payable for the software was ₹ 600,000 immediately and ₹ 400,000 in one year time. The other expenditure incurred were:-

Purchase tax : ₹ 1,00,000

Entry Tax : 10% (recoverable later from tax department)

Legal fees: ₹ 87,000

Consultancy fees for implementation : ₹ 1,20,000

Cost of capital of the company is 10%.

Calculate the cost of the software on initial recognition using the principles of Ind AS 38 Intangible Assets.

Solution

Particulars	Amount
Cash paid	600,000
Deferred consideration (₹ 400,000/1.1)	3,63,636
Purchase Tax	1,00,000
Entry tax *(not to be considered as it is a refundable tax)*	-
Legal fees	87,000
Consultancy fees for implementation	1,20,000
Total cost to be capitalised	**12,70,636**

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6.6.2 Acquisition as part of a business combination

6.6.2.1 Recognition criteria for intangible assets acquired as part of a business combination

- In accordance with Ind AS 103, *Business Combinations*, if an intangible asset is acquired in a business combination, the cost of that intangible asset is its fair value at the acquisition date. The fair value of an intangible asset will reflect market participants' expectations at the acquisition date about the probability that the expected future economic benefits embodied in the asset will flow to the entity.
- In other words, the entity expects there to be an inflow of economic benefits, even if there is uncertainty about the timing or the amount of the inflow. Therefore, the probability recognition criterion is always considered to be satisfied for intangible assets acquired in business combinations.
- An acquirer recognises at the acquisition date, separately from goodwill, an intangible asset of the acquiree, irrespective of whether the asset had been recognised by the acquiree before the business combination.
- This means that the acquirer recognises as an asset separately from goodwill an in-process research and development project of the acquiree if the project meets the definition of an intangible asset. An acquiree's in-process research and development project meets the definition of an intangible asset when it:

  (a) meets the definition of an asset; and

  (b) is identifiable, ie is separable or arises from contractual or other legal rights.

Measuring fair value

- If an intangible asset acquired in a business combination is separable or arises from contractual or other legal rights, sufficient information exists to measure reliably the fair value of the asset.
- When, for the estimates used to measure an intangible asset's fair value, there is a range of possible outcomes with different probabilities that uncertainty enters into the measurement of the asset's fair value.
- An intangible asset acquired in a business combination might be separable, but only together with a related contract, identifiable asset or liability. In such cases, the acquirer recognises the intangible asset separately from goodwill, but together with the related item.
- The acquirer may recognise a group of complementary intangible assets as a single asset provided the individual assets have similar useful lives. For example, the terms 'brand' and 'brand name' are often used as synonym for trademarks and other marks.

Illustration 6: Business Combination

On 31st March, 20X1, Earth India Ltd. paid ₹ 50,00,000 for a 100% interest in Sun India Ltd. At that date Sun Ltd.'s net assets had a fair value of ₹ 30,00,000. In addition, Sun Ltd. also held the following rights:

- Trade Mark named "GRAND" – valued at ₹ 180,000 using a discounted cash flow technique.
- Sole distribution rights to an electronic product; future cash flows from which are estimated to be ₹ 150,000 per annum for the next 6 years.

10% is considered an appropriate discount rate.

The 6 year, 10% annuity factor is 4.36.

Calculate goodwill and other Intangible assets arising on acquisition.

Solution

Particulars	Amount	Amount
Purchase Consideration (A)		50,00,000
Net Asset acquired	30,00,000	
Trade Mark	1,80,000	
Distribution Rights (1,50,000 x 4.36)	6,54,000	
Total (B)		(38,34,000)
Goodwill on Acquisition		11,66,000

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6.6.3 Acquisition by way of a government grant

An intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant. This may happen when a government transfers or allocates to an entity intangible assets such as airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources.

In accordance with Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance*, an entity should recognise both the intangible asset and the grant initially at fair value.

If an entity chooses not to recognise the asset initially at fair value, the entity recognises the asset initially at a nominal amount (the other treatment permitted by Ind AS 20) plus any expenditure that is directly attributable to preparing the asset for its intended use.

6.6.4 Exchange of assets

One or more intangible assets may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The cost of such an intangible asset is measured at fair value (even if an entity cannot immediately derecognise the asset given up) unless either:

(a) the exchange transaction lacks commercial substance; or

(b) the fair value of neither the asset received nor the asset given up is reliably measurable.

- If the acquired asset is not measured at fair value, its cost is measured at the carrying amount of the asset given up.
- An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

  (a) the configuration (ie risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or

  (b) the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange; and

  (c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.
- No intangible asset can be recognised unless its cost can be measured reliably. If an entity is able to measure reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure cost. However, if the fair value of the asset received is more clearly evident, then fair value of the asset received is taken up as cost.
- The fair value of an intangible asset is reliably measurable if:

  (a) the variability in the range of reasonable fair value measurements is not significant for that asset; or

(b) the probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value.

Illustration 7: Exchange of Asset

Sun Ltd acquired a software from Earth Ltd. in exchange for a telecommunication license. The telecommunication license is carried at ₹ 5,00,000 in the books of Sun Ltd. The Software is carried at ₹ 10,000 in the books of the Earth Ltd which is not the fair value.

Advise journal entries in the following situations in the books of Sun Ltd and Earth Ltd:-

1) *Fair value of software is ₹ 5,20,000 and fair value of telecommunication license is ₹ 5,00,000.*
2) *Fair Value of Software is not measureable. However similar Telecommunication license is transacted by another company at ₹ 4,90,000.*
3) *Neither Fair Value of Software nor Telecommunication license could be reliably measured.*

Solution

		₹ in '000
Situation	**Sun Ltd.**	**Earth Ltd.**
1	Software Dr. 500 To Telecommunication license 500 To Profit on Exchange Nil	Telecommunication license Dr. 520 To Software 10 To Profit on Exchange 510
2	Software Dr. 490 Loss on Exchange Dr. 10 To Telecommunication license 500 **Note:** The company may first recognise Impairment loss and then pass an entry. The effect is the same as impairment loss will also be charged to Income Statement.	Telecommunication license Dr. 490 To Software 10 To Profit on Exchange 480
3	Software Dr. 500 To Telecommunication license 500	Telecommunication license Dr. 10 To Software 10

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6.6.5 Internally generated goodwill

This standard prohibits the recognition of internally generated goodwill as an asset.

Internally generated goodwill is not recognised as an asset because it is not an identifiable resource (i.e. it is not separable nor does it arise from contractual or other legal rights) controlled by the entity that can be measured reliably at cost.

In some cases, expenditure is incurred to generate future economic benefits, but it does not result in the creation of an intangible asset that meets the recognition criteria in this Standard. Such expenditure is often described as contributing to internally generated goodwill.

Differences between the fair value of an entity and the carrying amount of its identifiable net assets at any time may capture a range of factors that affect the fair value of the entity. However, such differences do not represent the cost of intangible assets controlled by the entity.

6.6.6 Internally generated intangible assets

- It is sometimes difficult to assess whether an internally generated intangible asset qualifies for recognition because of problems in:

  (a) identifying whether and when there is an identifiable asset that will generate expected future economic benefits; and

  (b) determining the cost of the asset reliably.

  Therefore, in addition to complying with the general requirements for the recognition and initial measurement of an intangible asset, this standard includes additional recognition criteria for internally generated intangible assets which expand on the general recognition criteria.

- To assess whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into:

  (a) a research phase; and

  (b) a development phase.

- If an entity cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure on that project as if it were incurred in the research phase only.

Items that should not be recognised as internally generated intangible assets

This standard prohibits the recognition of internally generated goodwill as an asset. Some other internally generated items that are prohibited to be recognised as an intangible assets are brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets.

Research phase

- **Research** is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

- No intangible asset arising from research (or from the research phase of an internal project) should be recognised. Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred.

- In the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Therefore, this expenditure is recognised as an expense when it is incurred.

- Examples of research activities are:

  (a) activities aimed at obtaining new knowledge;

  (b) the search for, evaluation and final selection of, applications of research findings or other knowledge;

(c) the search for alternatives for materials, devices, products, processes, systems or services; and

(d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Development Phase

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

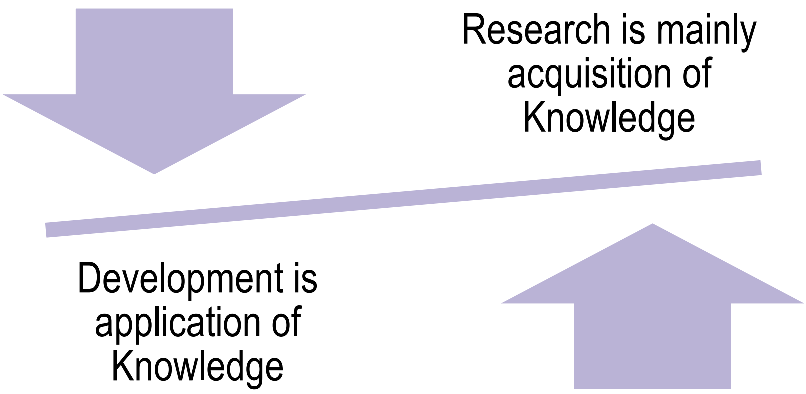
- **Examples of development activities are:**

- Design, construction and testing of pre-production or pre-use prototypes and models;
- Design of tools, jigs, moulds and dies involving new technology
- Design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production
- Design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services

An intangible asset arising from development (or from the development phase of an internal project) should be recognised if, and only if, an entity can demonstrate all of the following:

- Technical feasibility of completion of Intangible asset to make it available for use or sale
- Intention to complete the intangible asset and use or sell it
- Ability to use or sell the intangible asset.
- How the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
- Adequate resources (like technical, financial or others) to complete the development.
- Ability to measure reliably the expenditure attributable to the intangible asset during its development.

- In the development phase of an internal project, an entity can, in some instances, identify an intangible asset and demonstrate that the asset will generate probable future economic benefits. This is because the development phase of a project is further advanced than the research phase.
- To demonstrate how an intangible asset will generate probable future economic benefits, an entity assesses the future economic benefits to be received from the asset using the principles in Ind AS 36, *Impairment of Assets*. If the asset will generate economic benefits only in combination with other assets, the entity applies the concept of cash-generating units in Ind AS 36.
- Availability of resources to complete, use and obtain the benefits from an intangible asset can be demonstrated by, for example, a business plan showing the technical, financial and other resources needed and the entity's ability to secure those resources. In some cases, an entity demonstrates the availability of external finance by obtaining a lender's indication of its willingness to fund the plan.
- An entity's costing systems can often measure reliably the cost of generating an intangible asset internally, such as salary and other expenditure incurred in securing copyrights or licences or developing computer software.



Cost of an internally generated asset

The cost of an internally generated intangible asset for the purpose of initial measurement at recognition is the sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria including the additional criteria specified above.

Cost -Inclusions

The cost of an internally generated intangible asset comprises all directly attributable costs necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by management.

Examples of directly attributable costs are:

- Costs of materials and services used or consumed in generating the intangible asset
- Costs of employee benefits (as defined in Ind AS 19) arising from the generation of the intangible asset
- Fees to register a legal right
- Amortisation of patents and licences that are used to generate the intangible asset

The specific guidance is given for borrowing costs to be capitalized as part of the cost of a self-generated intangible asset.

This standard prohibits reinstatement of expenditure previously recognised as an expense.

Cost - Exclusions

The following are not components of the cost of an internally generated intangible asset:

(a) selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to preparing the asset for use;

(b) identified inefficiencies and initial operating losses incurred before the asset achieves planned performance; and

(c) expenditure on training staff to operate the asset.

Illustration 8

Venus Ltd. is preparing its accounts for the year ended 31st March, 20X2 and is unsure how to treat the following items.

1. *Company has completed a big marketing and advertising campaign costing ₹ 2,40,000. The finance director had authorised this campaign on the basis that it would create ₹ 5,00,000 of additional profits over the next three years.*
2. *A new product was developed during the year. The expenditure totalled ₹ 1,50,000 of which ₹ 1,00,000 was incurred prior to 30th September, 20X1, the date on which it became clear that the product was technically viable. The new product will be launched in the next four months and its recoverable amount is estimated at ₹ 70,000.*
3. *Staff participated in a training programme which cost the company ₹ 300,000. The training organisation had made a presentation to the directors of Baxter outlining that incremental profits to the business over the next twelve months would be ₹ 500,000.*

What amounts should appear as assets in Venus Ltd. Balance sheet as at 31st March, 20X2?

Solution

The treatment in Venus Ltd's balance sheet as at 31st March, 20X2 will be as follows:

1. Marketing and advertising campaign: no asset will be recognised, because it is not possible to identify future economic benefits that are attributable only to this campaign. All of the expenditure should be expensed in the statement of profit and loss account.
2. New product: development expenditure appearing in the statement of financial position will be valued at ₹ 50,000. The expenditure prior to the date on which the product becomes technically feasible is recognised in the statement of profit and loss account.
3. Training programme: no intangible asset will be recognised, because staff are not under the control of Venus Ltd. and when staff leave the benefits of the training, whatever they may be, also leave.

*****

Illustration 9 : Development Phase

Expenditure on a new production process in 20X1-20X2:

	₹
1st April to 31st December	*2,700*
1st January to 31st March	*900*
	3,600

The production process met the intangible asset recognition criteria for development on 1st January, 20X2. The amount estimated to be recoverable from the process is ₹ 1,000.

Expenditure incurred for development of the process in FY 20X2-20X3 is ₹ 6,000. Asset was brought into use on 31st March, 20X3 and is expected to be useful for 6 years.

What is the carrying amount of the intangible asset at 31st March, 20X2 and 31st March, 20X3. Also determine the charge to profit or loss for 20X1-20X2?

At 31st March, 20X4, the amount estimated to be recoverable from the process is ₹ 5,000.

What is the carrying amount of the intangible asset at 31st March, 20X4 and the charge to profit or loss for 20X3-20X4?

Solution

1) Expenditure to be transferred to profit or loss in 20X1-20X2

	₹
Total Expenditure	3,600
Less: Expenditure during development phase	(900)
Expenditure to be transferred to profit or loss	2,700

2) Carrying amount of intangible asset on 31st March, 20X2

Expenditure during Development Phase will be capitalised	₹ 900
(Recoverable amount is higher being ₹ 1,000, hence no impairment)	

3) Carrying amount of intangible asset on 31st March, 20X3

Carrying amount of intangible asset on 31st March, 20X2	₹ 900
Add: Further expenditure during development phase	6,000
Total capital expenditure on development phase	6,900

4) Expenditure to be charged to profit or loss in 20X3-20X4

Opening balance of Intangible Asset	6,900
Add: Amotisation for the year (6,900 / 6)	(1,150)
Carrying amount of intangible asset	5,750
Less: Recoverable Amount	(5,000)
Amount charged to profit or loss (Impairment Loss)	750

5) Carrying Amount of Intangible Asset on 31st March, 20X4

Value of Intangible Asset will be recoverable amount i.e. ₹ 5,000

*****

6.7. RECOGNITION OF AN EXPENSE

- Expenditure on an intangible item should be recognised as an expense when it is incurred unless:
  (a) it forms part of the cost of an intangible asset that meets the recognition criteria; or
  (b) the item is acquired in a business combination and cannot be recognised as an intangible asset. In such case, it forms part of the amount recognised as goodwill at the acquisition date.
- This standard states that the following types of expenditure should always be recognised as an expense:
  (a) expenditure on research (except when it is acquired as part of a business combination);
  (b) expenditure on start-up activities (ie start-up costs), unless this expenditure is included in the cost of an item of property, plant and equipment in accordance with Ind AS 16. Start-up costs may consist of:
    (i) establishment costs such as legal and secretarial costs incurred in establishing a legal entity;
    (ii) expenditure to open a new facility or business (ie pre-opening costs);
    (iii) expenditures for starting new operations or launching new products or processes (ie

pre-operating costs);

(c) expenditure on training activities;

(d) expenditure on advertising and promotional activities (including mail order catalogues); and

(e) expenditure on relocating or reorganising part or all of an entity.

- More generally, if expenditure does not give rise to an intangible asset:

  (a) for the supply of goods, an expense is recognised when the entity has a right to access those goods. An entity has a right to access goods when it owns them. Similarly, it has a right to access goods when they have been constructed by a supplier in accordance with the terms of a supply contract and the entity could demand delivery of them in return for payment.

  (b) for a supply of services, the entity recognises the expenditure as an expense when it receives the services. Services are received when they are performed by a supplier in accordance with a contract to deliver them to the entity and not when the entity uses them to deliver another service, for example, to deliver an advertisement to customers.

- This does not preclude an entity from recognising a prepayment as an asset when payment for goods has been made in advance of the entity obtaining a right to access those goods or in advance of the entity receiving those services.

- Expenditure on an intangible item that was initially recognised as an expense should not be recognised as part of the cost of an intangible asset at a later date.

6.8 MEASUREMENT AFTER RECOGNITION

An entity should choose either the cost model or the revaluation model as its accounting policy.

Cost Model	Revaluation Model

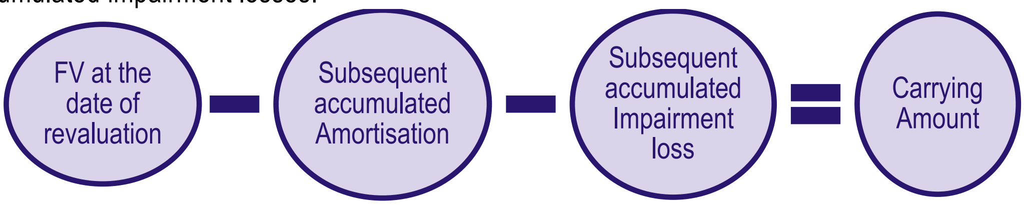
6.8.1 Cost model

After initial recognition, an intangible asset is carried at its cost less any accumulated amortisation and any accumulated impairment losses.

Cost − Accumulated amortisation − Accumulated impairment losses = Carrying Amount

6.8.2 Revaluation model

After initial recognition, an intangible asset is carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated amortisation and any subsequent accumulated impairment losses.



- For the purpose of revaluations under this Standard, fair value is measured by reference to an active market.
- The revaluation model does not allow:

  (a) the revaluation of intangible assets that have not previously been recognised as assets; or

  (b) the initial recognition of intangible assets at amounts other than cost.
- The revaluation model is applied after an asset has been initially recognised at cost. However, if only part of the cost of an intangible asset is recognised as an asset because the asset did not meet the criteria for recognition until part of the way through the process, the revaluation model may be applied to the whole of that asset.
- Also, the revaluation model may be applied to an intangible asset that was received by way of a Government grant and recognised at a nominal amount.

Frequency of revaluations

- Revaluations should be made with such regularity that at the end of the reporting period the carrying amount of the asset does not differ materially from its fair value.
- The frequency of revaluations depends on the volatility of the fair values of the intangible assets being revalued. If the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is necessary.
- Some intangible assets may experience significant and volatile movements in fair value, thus necessitating annual revaluation. Such frequent revaluations are unnecessary for intangible assets with only insignificant movements in fair value.

Scope of revaluations

- If an intangible asset is accounted for using the revaluation model, all the other assets in its class should also be accounted for using the same model, unless there is no active market for those assets.
- If an intangible asset in a class of revalued intangible assets cannot be revalued because there is no active market for this asset, the asset is carried at its cost less any accumulated amortisation and impairment losses.

- A class of intangible assets is a grouping of assets of a similar nature and use in an entity's operations.
- If the fair value of a revalued intangible asset can no longer be measured by reference to an active market, the carrying amount of the asset is its revalued amount at the date of the last revaluation by reference to the active market less any subsequent accumulated amortisation and any subsequent accumulated impairment losses.
- The fact that an active market no longer exists for a revalued intangible asset may indicate that the asset may be impaired and that it needs to be tested in accordance with Ind AS 36. If the fair value of the asset can be measured by reference to an active market at a subsequent measurement date, the revaluation model is applied from that date.

Accumulated amortisation at the date of revaluation

- When an intangible asset is revalued, the carrying amount of that asset is adjusted to the revalued amount. At the date of the revaluation, the asset is treated in one of the following ways:

  (a) the gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. For example, the gross carrying amount may be restated by reference to observable market data or it may be restated proportionately to the change in the carrying amount. The accumulated amortisation at the date of the revaluation is adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses; or

  (b) the accumulated amortisation is eliminated against the gross carrying amount of the asset.

Treatment of surplus or deficit arising on revaluation

- If an intangible asset's carrying amount is increased as a result of a revaluation, the increase shall be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus.
- However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.
- If an intangible asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognised in profit or loss.
- However, the decrease shall be recognised in other comprehensive income to the extent of any credit balance in the revaluation surplus in respect of that asset. The decrease recognised in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.
- The cumulative revaluation surplus included in equity may be transferred directly to retained earnings when the surplus is realised. The whole surplus may be realised on the retirement or disposal of the asset. Some realisation of the revaluation surplus may occur, however, through the use of the intangible asset.

- The amount of the surplus realised is the difference between amortisation based on the revalued carrying amount of the asset and amortisation that would have been recognised based on the asset's historical cost. The transfer from revaluation surplus to retained earnings is not made through profit or loss.

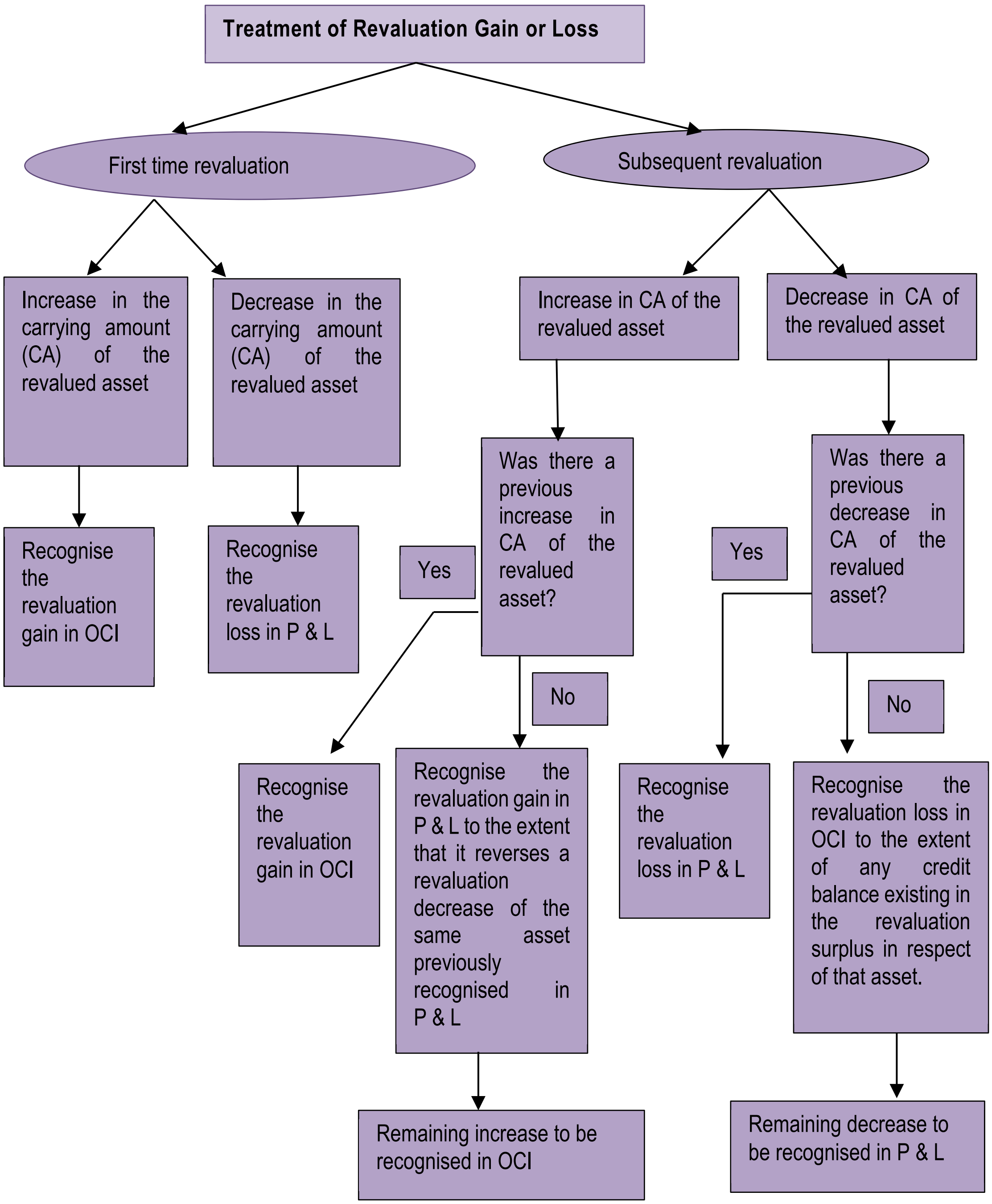


Illustration 10 : Revaluation Model

1. *Saturn Ltd. acquired an intangible asset on 31st March, 20X1 for ₹ 1,00,000. The asset was revalued at ₹ 1,20,000 on 31st March, 20X2and ₹ 85,000 on 31st March, 20X3.*
2. *Jupiter Ltd. acquired an intangible asset on 31st March, 20X1 for ₹ 1,00,000. The asset was revalued at ₹ 85,000 on 31st March, 20X2 and at ₹ 1,05,000 on 31st March, 20X3.*

Assuming that the year-end for both companies is 31st March, and that they both use the revaluation model, show how each of these transactions should be dealt with in the financial statements. Explain the treatment for revaluation of intangible asset. Ignore computation of amortization on them for ease of understanding.

Solution

Saturn Ltd.

₹ 20,000 revaluation increase on 31st March, 20X2 should be credited to the revaluation reserve and recognised in other comprehensive income. ₹ 20,000 of the revaluation decrease on 31st March, 20X3 should be debited to revaluation reserve and remaining ₹ 15,000 should be recognised as an expense.

Jupiter Ltd.

₹ 15,000 revaluation decrease on 31st March, 20X2 should be recognised as an expense in the Statement of Profit and loss. ₹ 15,000 out of the ₹ 20,000 increase on 31st March, 20X3 should be recognised as income. The remaining ₹ 5,000 should be credited to revaluation reserve and recognised in other comprehensive income.

Note: The above amount will be different if amortization of intangible asset is taken into consideration.

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6.9 USEFUL LIFE

- The accounting for an intangible asset is based on its useful life. An intangible asset with a finite useful life is amortised, and an intangible asset with an indefinite useful life is not amortised and tested for impairment.

Finite or indefinite useful life

- Entities are required to assess whether the useful life of an intangible asset is finite or indefinite and, if finite, the length of, or number of production or similar units constituting, that useful life.
- An intangible asset should be regarded by the entity as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

Factors for consideration in determining useful life

- Many factors are considered in determining the useful life of an intangible asset, including:

  - Expected usage of the asset by the entity
  - Product life cycles for the asset and public information on estimates of useful life of similiar asset used in a similiar way
  - Technical, technological , commercial or other type of obsolescence
  - Industrial Stability in which the asset operate and changes in market demand for the products or services from the output
  - Expected actions by competitors or potential competitors
  - Period of control over the asset and legal or similar limits on the use of assets, like expiry dates of related leases
  - Whether the useful life is dependent on the useful lives of other assets of the entity

- The useful life of an intangible asset reflects only that level of future maintenance expenditure required to maintain the asset at its standard of performance assessed at the time of estimating the asset's useful life, and the entity's ability and intention to reach such a level.
- A conclusion that the useful life of an intangible asset is indefinite should not depend on planned future expenditure in excess of that required to maintain the asset at that standard of performance.
- This standard notes that, given the history of rapid changes in technology, computer software and many other intangible assets are susceptible to technological obsolescence. Therefore, it will often be the case that their useful life is short. Expected future reductions in the selling price of an item that was produced using an intangible asset could indicate the expectation of technological or commercial obsolescence of the asset, which, in turn, might reflect a reduction of the future economic benefits embodied in the asset.
- The useful life of an intangible asset may be very long or even indefinite. Uncertainty justifies estimating the useful life of an intangible asset on a prudent basis, but it does not justify choosing a life that is unrealistically short.

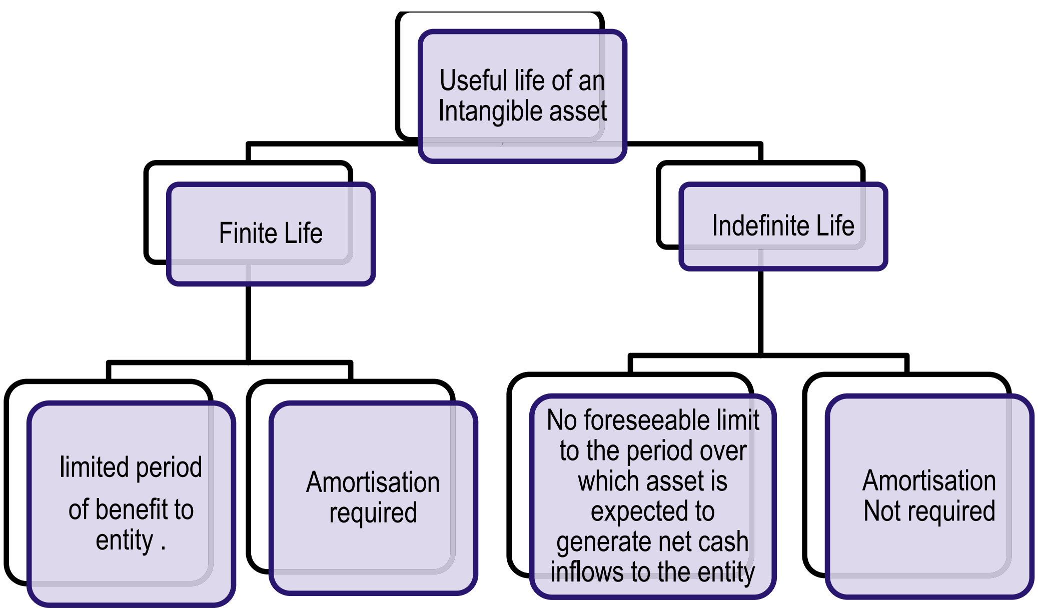
Intangible asset arising from contractual or other legal rights

- The useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual or other legal rights, but may be shorter depending on the period over which the entity expects to use the asset.
- If the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the intangible asset shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost.
- Existence of the following factors, among others, indicates that an entity would be able to renew the contractual or other legal rights without significant cost:

  (a) there is evidence, possibly based on experience, that the contractual or other legal rights will be renewed. If renewal is contingent upon the consent of a third party, this includes evidence that the third party will give its consent;

  (b) there is evidence that any conditions necessary to obtain renewal will be satisfied; and

  (c) the cost to the entity of renewal is not significant when compared with the future economic benefits expected to flow to the entity from renewal.
- If the cost of renewal is significant when compared with the future economic benefits expected to flow to the entity from renewal, the 'renewal' cost represents, in substance, the cost to acquire a new intangible asset at the renewal date.
- The useful life of a reacquired right recognised as an intangible asset in a business combination is the remaining contractual period of the contract in which the right was granted and shall not include renewal periods.



6.10 INTANGIBLE ASSETS WITH FINITE USEFUL LIVES

6.10.1 Depreciable amount to be amortised over the asset's useful life

- The depreciable amount of an intangible asset with a finite useful life is allocated on a systematic basis over its useful life. The depreciable amount of an asset is defined as the cost of an asset, or other amount substituted for cost, less its residual value.
- Amortisation is usually recognised in profit or loss. However, sometimes the future economic benefits embodied in an asset are absorbed in producing other assets. In this case, the amortisation charge constitutes part of the cost of the other asset and is included in its carrying amount. For example, the amortisation of intangible assets used in a production process is included in the carrying amount of inventories (see Ind AS 2, *Inventories*).

6.10.2 Residual Value

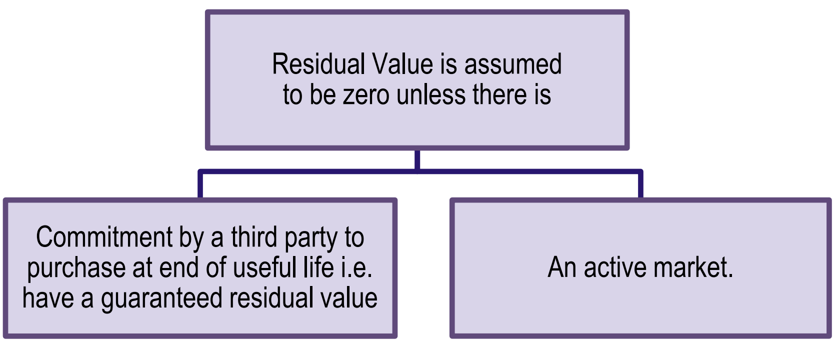
- The residual value of an intangible asset with a finite useful life should be assumed to be zero unless:

  (a) there is a commitment by a third party to purchase the asset at the end of its useful life; or

  (b) there is an active market (as defined in Ind AS 113) for the asset and:

    (i) residual value can be determined by reference to that market; and

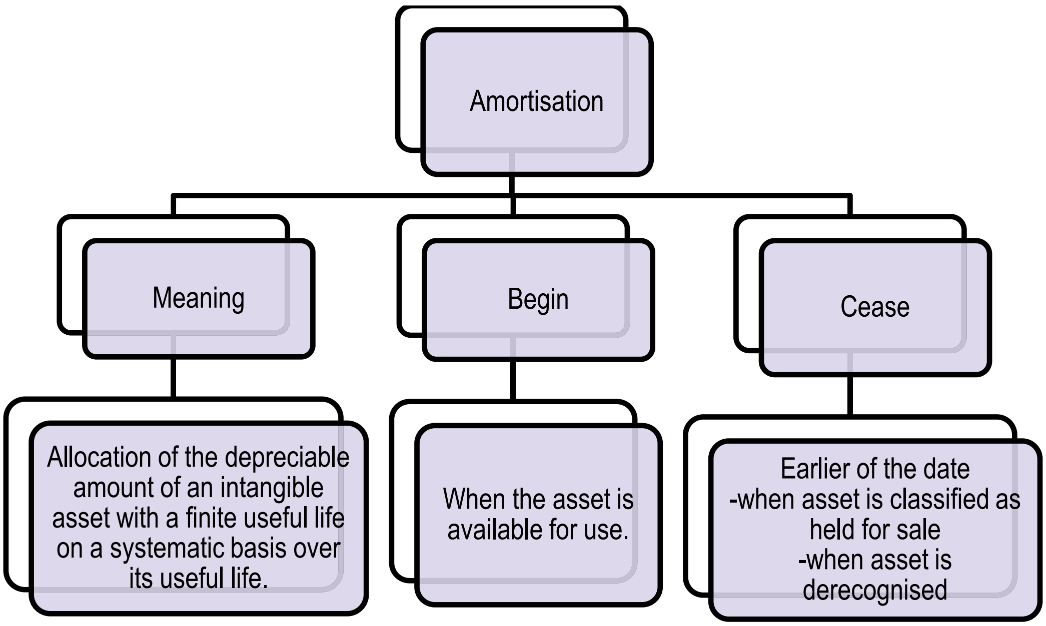
    (ii) it is probable that such a market will exist at the end of the asset's useful life.



- The residual value is reviewed at least at each financial year-end. An estimate of an asset's residual value is based on the amount recoverable from disposal using prices prevailing at the date of the estimate for the sale of a similar asset that has reached the end of its useful life and has operated under conditions similar to those in which the asset will be used.
- A change in the asset's residual value is accounted for as a change in an accounting estimate in accordance with Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors.

- The residual value of an intangible asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the asset's amortisation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount.

6.10.3 Amortisation period



Commencement of amortisation

Amortisation commence from the date when the asset is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

Cessation of amortisation

Amortisation ceases at the earlier of:

(a) the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with Ind AS 105; and

(b) the date that the asset is derecognised.

Amortisation of an intangible asset with a finite useful life does not cease when the intangible asset is no longer used, unless the asset has been fully depreciated or is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with Ind AS 105.

Review of amortisation period

The amortisation period for an intangible asset with a finite useful life should be reviewed at least at each financial year-end. If the expected useful life of the asset is different from previous estimates, the amortisation period should be changed accordingly. Such change is accounted for as a change in accounting estimates in accordance with Ind AS 8.

6.10.4 Amortisation method

The amortisation method used should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably, the straight-line method should be used.

A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the units of production method.

In choosing an appropriate amortisation method, an entity could determine the predominant limiting factor that is inherent in the intangible asset. For example, the contract that sets out the entity's rights over its use of an intangible asset might specify the entity's use of the intangible asset as a predetermined number of years (i.e. time), as a number of units produced or as a fixed total amount of revenue to be generated.

Identification of such a predominant limiting factor could serve as the starting point for the identification of the appropriate basis of amortisation, but another basis may be applied if it more closely reflects the expected pattern of consumption of economic benefits.

The amortisation method for an intangible asset with a finite useful life should be reviewed at least at each financial year-end. If there has been a change in the expected pattern of consumption of the future economic benefits embodied in the asset, the amortisation method should be changed to reflect the changed pattern. Such change is accounted for as a change in accounting estimates in accordance with Ind AS 8.

Amortisation method based on revenue

There is a rebuttable presumption that an amortisation method that is based on the revenue generated by an activity that includes the use of an intangible asset is inappropriate.

The revenue generated by an activity that includes the use of an intangible asset typically reflects factors that are not directly linked to the consumption of the economic benefits embodied in the intangible asset. For example, revenue is affected by other inputs and processes, selling activities and changes in sales volumes and prices. The price component of revenue may be affected by inflation, which has no bearing upon the way in which an asset is consumed.

This presumption can be overcome only in the limited circumstances:

(a) in which the intangible asset is expressed as a measure of revenue, as described in paragraph 98C; or

(b) when it can be demonstrated that revenue and the consumption of the economic benefits of the intangible asset are highly correlated.

In the circumstance in which the predominant limiting factor that is inherent in an intangible asset is the achievement of a revenue threshold, the revenue to be generated can be an appropriate basis for amortisation. For example, an entity could acquire a concession to explore and extract gold from a gold mine. The expiry of the contract might be based on a fixed amount of total revenue to be generated from the extraction (for example, a contract may allow the extraction of gold from the mine until total cumulative revenue from the sale of gold reaches ₹ 2 billion) and not be based on time or on the amount of gold extracted.

In another example, the right to operate a toll road could be based on a fixed total amount of revenue to be generated from cumulative tolls charged (for example, a contract could allow operation of the toll road until the cumulative amount of tolls generated from operating the road reaches ₹ 100 lakh). In the case in which revenue has been established as the predominant limiting factor in the contract for the use of the intangible asset, the revenue that is to be generated might be an appropriate basis for amortising the intangible asset, provided that the contract specifies a fixed total amount of revenue to be generated on which amortisation is to be determined.

Example : An acquired customer list

A direct-mail marketing company acquires a customer list and expects that it will be able to derive benefit from the information on the list for at least one year, but no more than three years.

The customer list would be amortised over management's best estimate of its useful life, say 18 months. Although the direct-mail marketing company may intend to add customer names and other information to the list in the future, the expected benefits of the acquired customer list relate only to the customers on that list at the date it was acquired. The customer list also would be reviewed for impairment in accordance with Ind AS 36, *Impairment of Assets,* by assessing at the end of each reporting period whether there is any indication that the customer list may be impaired.

Example : An acquired patent that expires in 15 years

The product protected by the patented technology is expected to be a source of net cash inflows for at least 15 years. The entity has a commitment from a third party to purchase that patent in five years for 60 per cent of the fair value of the patent at the date it was acquired, and the entity intends to sell the patent in five years.

The patent would be amortised over its five-year useful life to the entity, with a residual value equal to the present value of 60 per cent of the patent's fair value at the date it was acquired. It may be noted that the estimated useful life has to be considered with reference to the entity only though the total life of the patent is much higher i.e., 15 years. The patent would also be reviewed for impairment in accordance with Ind AS 36 by assessing at the end of each reporting period whether there is any indication that it may be impaired.

Example : An acquired copyright that has a remaining legal life of 50 years

An analysis of consumer habits and market trends provides evidence that the copyrighted material will generate net cash inflows for only 30 more years.

It needs to be noted that although the remaining legal life of the patent is 50 years, however the useful life from the entity's perspective is only 30 years. The copyright would be amortised over its 30-years estimated useful life. The copyright also would be reviewed for impairment in accordance with Ind AS 36 by assessing at the end of each reporting period whether there is any indication that it may be impaired.

Example A: An acquired broadcasting licence that expires in five years

The broadcasting licence is renewable every 10 years if the entity provides at least an average level of service to its customers and complies with the relevant legislative requirements. The licence may be renewed indefinitely at little cost and has been renewed twice before the most recent acquisition. The acquiring entity intends to renew the licence indefinitely and evidence supports its ability to do so. Historically, there has been no compelling challenge to the licence renewal. The technology used in broadcasting is not expected to be replaced by another technology at any time in the foreseeable future. Therefore, the licence is expected to contribute to the entity's net cash inflows indefinitely.

The broadcasting licence would be treated as having an indefinite useful life because it is expected to contribute to the entity's net cash inflows indefinitely. Therefore, the licence would not be amortised until its useful life is determined to be finite. The licence would be tested for impairment in accordance with Ind AS 36 annually and whenever there is an indication that it may be impaired.

Example : The broadcasting licence in Example A

The licensing authority subsequently decides that it will no longer renew broadcasting licences, but rather will auction the licences. At the time the licensing authority's decision is made, the entity's broadcasting licence has three years until it expires. The entity expects that the licence will continue to contribute to net cash inflows until the licence expires.

Because the broadcasting licence can no longer be renewed, its useful life is no longer indefinite. Thus, the acquired licence would be amortised over its remaining three-year useful life and immediately tested for impairment in accordance with Ind AS 36.

Example : An acquired airline route authority between two European cities that expires in three years

The route authority may be renewed every five years, and the acquiring entity intends to comply with the applicable rules and regulations surrounding renewal. Route authority renewals are routinely granted at a minimal cost and historically have been renewed when the airline has complied with the applicable rules and regulations. The acquiring entity expects to provide service indefinitely between the two cities from its hub airports and expects that the related supporting infrastructure (airport gates, slots, and terminal facility leases) will remain in place at those airports for as long as it has the route authority. An analysis of demand and cash flows supports those assumptions.

Since the facts and circumstances support the acquiring entity's ability to continue providing air service indefinitely between the two cities, the intangible asset related to the route authority is treated as having an indefinite useful life. Therefore, the route authority would not be amortised until its useful life is determined to be finite. It would be tested for impairment in accordance with Ind AS 36 annually and whenever there is an indication that it may be impaired.

Example : An acquired trademark used to identify and distinguish a leading consumer product that has been a market-share leader for the past eight years

The trademark has a remaining legal life of five years but is renewable every 10 years at little cost. The acquiring entity intends to renew the trademark continuously and evidence supports its ability to do so. An analysis of (1) product life cycle studies, (2) market, competitive and environmental trends, and (3) brand extension opportunities provides evidence that the trademarked product will generate net cash inflows for the acquiring entity for an indefinite period.

The trademark would be treated as having an indefinite useful life because it is expected to contribute to net cash inflows indefinitely. Though the remaining legal life is five years, the possibility that it can be renewed every ten years and the entity's intention to renew the same leads to the conclusion that the trademark has an indefinite useful life. Therefore, the trademark would not be amortised until its useful life is determined to be finite. It would be tested for impairment in accordance with Ind AS 36 annually and whenever there is an indication that it may be impaired.

Example : A trademark acquired 10 years ago that distinguishes a leading consumer product

The trademark was regarded as having an indefinite useful life when it was acquired because the trademarked product was expected to generate net cash inflows indefinitely. However, unexpected competition has recently entered the market and will reduce future sales of the product. Management estimates that net cash inflows generated by the product will be 20 per cent less for the foreseeable future. However, management expects that the product will continue to generate net cash inflows indefinitely at those reduced amounts.

As a result of the projected decrease in future net cash inflows, the entity determines that the estimated recoverable amount of the trademark is less than its carrying amount, and an impairment loss is recognised. Since it is still regarded as having an indefinite useful life, the trademark would continue not to be amortised but would be tested for impairment in accordance with Ind AS 36 annually and whenever there is an indication that it may be impaired.

Example : Trademark for a line of products that was acquired several years ago in a business combination

At the time of the business combination the acquiree had been producing the line of products for 35 years with many new models developed under the trademark. At the acquisition date the acquirer expected to continue producing the line, and an analysis of various economic factors indicated there was no limit to the period the trademark would contribute to net cash inflows. Consequently, the trademark was not amortised by the acquirer. However, management has recently decided that production of the product line will be discontinued over the next four years.

Since the useful life of the acquired trademark is no longer regarded as indefinite, the carrying amount of the trademark would be tested for impairment in accordance with Ind AS 36 and amortised over its remaining four-year useful life.

6.11 INTANGIBLE ASSETS WITH INDEFINITE USEFUL LIVES

- An intangible asset with an indefinite useful life should not be amortised.
- In accordance with Ind AS 36, an entity is required to test an intangible asset with an indefinite useful life for impairment by comparing its recoverable amount with its carrying amount
  (a) annually; and
  (b) whenever there is an indication that the intangible asset may be impaired.
- The useful life of an intangible asset that is not being amortised should be reviewed each period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite is accounted for as a change in an accounting estimate in accordance with Ind AS 8.
- In accordance with Ind AS 36, reassessing the useful life of an intangible asset as finite rather than indefinite is an indicator that the asset may be impaired. As a result, the entity tests the asset for impairment by comparing its recoverable amount, determined in accordance with Ind AS 36, with its carrying amount, and recognising any excess of the carrying amount over the recoverable amount as an impairment loss.

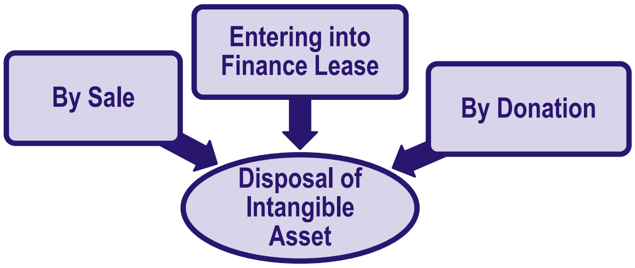
6.12 IMPAIRMENT

- To determine whether an intangible asset is impaired, an entity applies Ind AS 36. That Standard explains when and how an entity reviews the carrying amount of its assets, how it determines the recoverable amount of an asset and when it recognises or reverses an impairment loss.
- For an intangible asset with indefinite useful lives, an impairment review is required at least annually.

6.13 RETIREMENTS AND DISPOSALS

- An intangible asset should be derecognised:
  (a) on disposal; or
  (b) when no future economic benefits are expected from its use or disposal.

The disposal of an intangible asset may occur in a variety of ways (e.g. by sale, by entering into a finance lease, or by donation).



- The gain or loss arising from the derecognition of an intangible asset should be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the asset. It is to be recognised in profit or loss when the asset is derecognised (unless Ind AS 116 requires otherwise on a sale and leaseback). Gains should not be classified as revenue.
- If in accordance with the recognition principle an entity recognises in the carrying amount of an asset the cost of a replacement for part of an intangible asset, then it derecognises the carrying amount of the replaced part. If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or internally generated.
- The date of disposal of an intangible asset is the date that the recipient obtains control of that asset in accordance with the requirements for determining when a performance obligation is satisfied as per Ind AS 115. ***Ind AS 116 applies to disposal by a sale and leaseback.***
- In the case of a reacquired right in a business combination, if the right is subsequently reissued (sold) to a third party, the related carrying amount, if any, should be used in determining the gain or loss on reissue.
- The amount of consideration to be included in the gain or loss arising from the derecognition of an intangible asset is determined in accordance with the requirements for determining the transaction price (as per Ind AS 115). Subsequent changes to the estimated amount of the consideration included in the gain or loss shall be accounted for in accordance with the requirements for changes in the transaction price in Ind AS 115.

6.14 DISCLOSURE

1) Disclosure – general

An entity should disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

a) whether the useful lives are indefinite or finite and, if finite, the useful lives or the amortisation rates used;

b) the amortisation methods used for intangible assets with finite useful lives;

c) the gross carrying amount and any accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period;

d) the line item(s) of the statement of profit and loss in which any amortisation of intangible assets is included; and

e) a reconciliation of the carrying amount at the beginning and end of the period showing:

   (i) additions, indicating separately those from internal development, those acquired separately, and those acquired through business combinations;

   (ii) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with Ind AS 105 and other disposals;

   (iii) increases or decreases during the period resulting from revaluations and from impairment losses recognised or reversed in other comprehensive income;

   (iv) impairment losses recognised in profit or loss during the period;

   (v) impairment losses reversed in profit or loss during the period;

   (vi) any amortisation recognised during the period;

   (vii) net exchange differences arising on the translation of the financial statements into the presentation currency, and on the translation of a foreign operation into the presentation currency of the entity; and

   (viii) other changes in the carrying amount during the period.

2) Intangible assets having an indefinite useful life

For an intangible asset assessed as having an indefinite useful life, financial statement should disclose the carrying amount of that asset and the reasons supporting the assessment of an indefinite useful life. In giving these reasons, the entity shall describe the factor(s) that played a significant role in determining that the asset has an indefinite useful life.

3) Intangible assets that are individually material

Financial statement should disclose a description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the entity's financial statements.

4) Intangible assets acquired by way of government grant

For intangible assets acquired by way of a government grant and initially recognised at fair value, the financial statement should disclose:

a) the fair value initially recognised for these assets;

b) their carrying amount; and

c) whether they are measured after recognition under the cost model or the revaluation model.

5) Title restrictions and capital commitments

The financial statement should also disclose:

the existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities and the amount of contractual commitments for the acquisition of intangible assets.

6) Intangible assets carried at revalued amounts

If intangible assets are accounted for at revalued amounts, an entity should disclose the following:

a) by class of intangible assets:

   (i) the effective date of the revaluation;

   (ii) the carrying amount of revalued intangible assets; and

   (iii) the carrying amount that would have been recognised had the revalued class of intangible assets been measured after recognition using the cost model; and

b) the amount of the revaluation surplus that relates to intangible assets at the beginning and end of the period, indicating the changes during the period and any restrictions on the distribution of the balance to shareholders.

If necessary, it is acceptable to aggregate the classes of revalued assets into larger classes for disclosure purposes. However, classes are not aggregated if this would result in the combination of a class of intangible assets that includes amounts measured under both the cost and revaluation models.

7) Research and development expenditure

An entity should disclose the aggregate amount of research and development expenditure recognised as an expense during the period.

8) Other information

An entity is encouraged, but not required, to disclose the following information:

a) a description of any fully amortised intangible asset that is still in use; and

b) a brief description of significant intangible assets controlled by the entity but not recognised as assets because they did not meet the recognition criteria in this Standard or because they were acquired or generated before this standard was effective.

Illustration 11

X Limited engaged in the business of manufacturing fertilisers entered into a technical collaboration agreement with a foreign company Y Limited. As a result, Y Limited would provide the technical know-how enabling X Limited to manufacture fertiliser in a more efficient way. X Limited paid ₹ 10,00,00,000 for the use of know-how for a period of 5 years. X Limited estimates the production of fertiliser as follows:

Year	(In metric tons)
1	50,000
2	70,000
3	1,00,000
4	1,20,000
5	1,10,000

At the end of the 1st year, it achieved its targeted production. At the end of 2nd year, 65,000 metric tons of fertiliser was being manufactured, and X Limited considered to revise the estimates for the next 3 years. The revised figures are 85,000, 1,05,000 and 1,15,000 metric tons for year 3, 4 & 5 respectively.

How will X Limited amortise the technical know-how fees as per Ind AS 38?

Solution

Based on the above data, it may be suitable for X Ltd. to use unit of production method for amortisation of technical know-how.

The total estimated unit to be produced 4,50,00 MT. The technical know-how will be amortised on the basis of the ratio of yearly production to total production.

The first year charge should be a proportion of 50,000/4,50,000 on ₹ 10,00,00,000 = ₹ 1,11,11,111.

At the end of 2nd year, as per revised estimate the total number of units to be produced in future are 3,70,000 MT (ie 65,000 + 85,000 + 1,05,000 + 1,15,000).

The amortisation for second year will be 65,000 / 3,70,000 on (10,00,00,000 – 1,11,11,111) ie 1,56,15,615 and so on for remaining years unless the estimates are again revised.

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Illustration 12

X Ltd. purchased a patent right on 1st April, 20X1, for ₹ 3,00,000; which has a legal life of 15 years. However, due to the competitive nature of the product, the management estimates a useful life of only 5 years. Straight-line amortisation is determined by the management to be the best method. As at 1st April, 20X2, management is uncertain that the process can actually be made economically *feasible, and decides to write down the patent to an estimated market value of ₹ 1,50,000 and decides to amortise over 2 years. As at 1st April, 20X3, having perfected the related production process, the asset is now appraised at a value of ₹ 3,00,000. Furthermore, the estimated useful life is now believed to be 4 more years. Determine the value of intangible asset at the end of each financial year?*

Solution

Value as on 31st March, 20X2

Original cost	₹ 3,00,000
Less: amortisation	(₹ 60,000)
Net Value	₹ 2,40,000

Value as on 31st March, 20X3

On 1st April, 20X2, the impairment is recorded by writing down the asset to the estimated value of ₹ 1,50,000, which necessitates a ₹ 90,000 charge to profit & loss (carrying value, ₹ 2,40,000 less fair value ₹ 1,50,000).

Amortisation provided for the financial year 20X2-20X3 is ₹ 75,000 (₹ 1,50,000/2)

Net value is = ₹ 1,50,000 – ₹ 75,000 = ₹ 75,000.

Value as on 31st March, 20X4

As of 1st April, 20X3, the carrying value of the patent is ₹ 75,000.

Revalued amount of patent is ₹ 3,00,000.

Out of total revaluation gain of ₹ 2,25,000, ₹ 90,000 will be charged to profit & loss and balance amount of ₹ 1,35,000 (₹ 2,25,000 – ₹ 90,000) will be credited to revaluation reserve.

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Illustration 13

X Pharmaceutical Ltd. seeks your opinion in respect of following accounting transactions:

1. *Acquired a 4 year license to manufacture a specialised drug at a cost of ₹ 1,00,00,000 at the start of the year. Production commenced immediately.*
2. *Also purchased another company at the start of year. As part of that acquisition, X Pharmacy Ltd. acquired a brand with a fair value of ₹ 3,00,00,000 based on sales revenue. The life of the brand is estimated at 15 years.*
3. *Spent ₹ 1,00,00,000 on an advertising campaign during the first six months. Subsequent sales have shown a significant improvement and it is expected this will continue for 3 years.*

4. *It has commenced developing a new drug 'Drug-A'. The project cost would be ₹ 10,00,00,000. Clinical trial proved successful and such drug is expected to generate revenue over the next 5 years.*

   Cost incurred (accumulated) till 31st March, 20X1 is ₹ 5,00,00,000.

   Balance cost incurred during the financial year 20X1-20X2 is ₹ 5,00,00,000.

5. *It has also commenced developing another drug 'Drug B'. It has incurred ₹ 50,00,000 towards research expenses till 31st March, 20X2. The technological feasibility has not yet been established.*

How the above transactions will be accounted for in the books of account of X Pharmaceutical Ltd?

Solution

X Pharmaceutical Ltd. is advised as under:

1. It should recognise the drug license as an intangible asset, because it is a separate external purchase, separately identifiable asset and considered successful in respect of feasibility and probable future cash inflows.

   The drug license should be recorded at ₹ 1,00,00,000.

2. It should recognise the brand as an intangible asset because it is purchased as part of acquisition and it is separately identifiable. The brand should be amortised over a period of 15 years.

   The brand will be recorded at ₹ 3,00,00,000.

3. The advertisement expenses of ₹ 1,00,00,000 should be expensed off.

4. The development cost incurred during the financial year 20X1-20X2 should be capitalised.

   Cost of intangible asset (Drug A) as on 31st March, 20X2

Opening cost	₹ 5,00,00,000
Development cost	₹ 5,00,00,000
Total cost	₹ 10,00,00,000

5. Research expenses of ₹ 50,00,000 incurred for developing 'Drug B' should be expensed off since technological feasibility has not yet established.

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6.15 SIGNIFICANT DIFFERENCES IN IND AS 38 *VIS-À-VIS* AS 26

S. No.	Particular	Ind AS 38	AS 26
1.	Exclusions:	Ind AS 38 does not include any such exclusion specifically as these are covered by other accounting standards. Ind AS 38 contains a scope exclusion with regard to the amortisation method for intangible assets arising from service concession arrangements in respect of toll roads recognised in the financial statements before the beginning of the first Ind AS financial reporting period as per the previous GAAP, i.e., Schedule II to the Companies Act, 2013	Paragraph 5 of AS 26, does not apply to accounting issues of specialised nature that arise in respect of accounting for discount or premium relating to borrowings and ancillary costs incurred in connection with the arrangement of borrowings, share issue expenses and discount allowed on the issue of shares.
2.	Definition of Intangible Assets:	Ind AS 38, the requirement for the asset to be held for use in the production or supply of goods or services, for rental to others, or for administrative purposes has been removed from the definition of an intangible asset.	AS 26 standard defines an intangible asset as an identifiable non-monetary asset without physical substance held for use in the production or supply of goods or services, for rental to others, or for administrative purposes
3.	Identifiability	Ind AS 38 provides detailed guidance in respect of identifiability.	AS 26 does not define 'identifiability', but states that an intangible asset could be distinguished clearly from goodwill if the asset was separable, but that separability was not a necessary condition for identifiability.
4.	Separately Acquired	As per Ind AS 38, in the case of separately acquired intangibles, the criterion of probable inflow of expected future economic benefits is	There is no such provision in AS 26.

	Intangible Assets	always considered satisfied, even if there is uncertainty about the timing or the amount of the inflow.	
5.	Revenue Based Amortisation Method	In Ind AS 38 there is a rebuttable presumption that an amortisation method that is based on the revenue generated by an activity that includes the use of an intangible asset is inappropriate. Ind AS 38 allows use of revenue based method of amortisation of intangible asset, in a limited way.	AS 26 does not specifically deal with revenue based amortisation method.
6.	Payment Deferred beyond Normal Credit Terms	Under Ind AS 38, if payment for an intangible asset is deferred beyond normal credit terms, the difference between this amount and the total payments is recognised as interest expense over the period of credit unless it is capitalised as per Ind AS 23.	There is no such provision in AS 26
7.	Intangible Assets acquired in Business Combination	Ind AS 38 deals in detail in respect of intangible assets acquired in a business combination.	AS 26 refers only to intangible assets acquired in an amalgamation in the nature of purchase and does not refer to business combinations as a whole.
8.	Subsequent Expenditure on in Process Research and Development Project	Ind AS 38 gives guidance for the treatment of such expenditure	AS 26 is silent regarding the treatment of subsequent expenditure on an in-process research and development project acquired in a business combination
9.	Intangible Assets Acquired in Exchange	Ind AS 38 requires that if an intangible asset is acquired in exchange of a non-monetary asset, it should be recognised at the fair value of the asset given up unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable.	AS 26 requires the principles of AS 10 to be followed which require that when an asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given. It may be appropriate to consider also the fair market value of the asset

			acquired if this is more clearly evident. An alternative accounting treatment to record the asset acquired at the net book value of the asset given up; in each case an adjustment is made for any balancing receipt or payment of cash or other consideration also.
10.	Intangible Assets acquired Free of Charge or for a Nominal Consideration by way of Government Grant	As per Ind AS 38, when intangible assets are acquired free of charge or for nominal consideration by way of government grant, an entity should, in accordance with Ind AS 20, record both the grant and the intangible asset at fair value. An alternative course that is sometimes followed is to record both asset and grant at a nominal amount.	As per AS 26, intangible assets acquired free of charge or for nominal consideration by way of government grant is recognised at nominal value or at acquisition cost, as appropriate plus any expenditure that is attributable to making the asset ready for intended use.
11.	Useful Life of an Intangible Asset	That rebuttable presumption is not there in Ind AS 38. Ind AS 38 recognizes that the useful life of an intangible asset can even be indefinite subject to fulfillment of certain conditions, in which case it should not be amortised but should be tested for impairment.	AS 26 is based on the assumption that the useful life of an intangible asset is always finite, and includes a rebuttable presumption that the useful life cannot exceed ten years from the date the asset is available for use
12.	Guidance on Certain Issues	In Ind AS 38, guidance is available on cessation of capitalisation of expenditure, de-recognition of a part of an intangible asset and useful life of a reacquired right in a business combination.	There is no such guidance in AS 26 on these aspects.
13.	Valuation Model as Accounting Policy	Ind AS 38 permits an entity to choose either the cost model or the revaluation model as its accounting policy	In AS 26, revaluation model is not permitted.
14.	Intangible Assets recognised as an Expense	Ind AS 38 provides more guidance on recognition of intangible items recognised as expense. Ind AS 38 clarifies that in respect of prepaid	Further, unlike AS 26 mail order catalogues have been specifically identified as a form of advertising and

		expenses, recognition of an asset would be permitted only upto the point at which the entity has the right to access the goods or upto the receipt of services.	promotional activities which are required to be expensed.
15.	Contractual or Legal Rights may be Shorter than Legal Life	Ind AS 38 acknowledges that the useful life of an intangible asset arising from contractual or legal rights maybe shorter than the legal life.	AS 26 does not include such a provision
16.	Amortisation Lower than under SLM	Ind AS 38 does not contain any such provision.	As per AS 26, there will rarely, if ever, be persuasive evidence to support an amortisation method for intangible assets that results in a lower amount of accumulated amortisation than under straight-line method.
17.	Subsequent Increase of Residual Value for Changes in Prices or Value	Under Ind AS 38, the residual value is reviewed at least at each financial year-end. If it increases to an amount equal to or greater than the asset's carrying amount, amortisation charge is zero unless the residual value subsequently decreases to an amount below the asset's carrying amount.	However, AS 26 specifically requires that the residual value is not subsequently increased for changes in prices or value.
18.	Change in Method of Amortization	This is a change in accounting estimate.	The change in the method of amortisation is a change in accounting policy
19.	Annual Impairment Testing	There is no such requirement in Ind AS 38.	AS 26 also requires annual impairment testing of an intangible asset not yet available for use.
20.	Intangible Assets Retired from Use and Held for Sale:	Ind AS 38 does not include such intangible assets since they would be covered by Ind AS 105.	Intangible assets retired from use and held for sale are covered by AS 26.

TEST YOUR KNOWLEDGE

Questions

1. X Ltd. is engaged in the business of publishing Journals. They acquired 50% stake in Y Ltd., a company in the same industry. X Ltd. paid purchase consideration of ₹ 10,00,00,000 and fair value of net asset acquired is ₹ 8,50,00,000. The above purchase consideration includes:

   (a) ₹ 30,00,000 for obtaining the skilled staff of Y Ltd.

   (b) ₹ 50,00,000 by way of payment towards 'Non-compete Fee' so as to restrict Y Ltd. to compete in the same line of business for next 5 years.

   How should the above transactions be accounted for by X Ltd?

2. X Ltd. purchased a franchise from a restaurant chain at a cost of ₹ 1,00,00,000 and the franchise has 10 years life. In addition, the franchise agreement mentions that the franchisee would also pay the franchisor royalty as a percentage of sales made. Can the franchise rights be treated as an intangible asset under Ind AS 38?

3. An entity regularly places advertisements in newspapers advertising its products and includes a reply slip that informs individuals replying to the advertisement that the entity may pass on the individual's details to other sellers of similar products, unless the individual ticks a box in the advertisement.

   Over a period of time the entity has assembled a list of customers' names and addresses. The list is provided to other entities for a fee. The entity would like to recognise an asset in respect of the expected future economic benefits to be derived from the list. Can the customer list be treated as an intangible asset under Ind AS 38?

4. A software company X Ltd. is developing new software for the telecom industry. It employs 100 employs engineers trained in that particular discipline who are engaged in the development of the software. X Ltd. feels that it has an excellent HR policy and does not expect any of its employees to leave in the near future. It wants to recognise these set of engineers as a human resources asset in the form of an intangible asset. What would be your advice to X Ltd?

5. X Ltd. has acquired a telecom license from Government to operate mobile telephony in two states of India. Can the cost of acquisition be capitalised as an intangible asset under Ind AS 38?

6. X Ltd. purchased a standardised finance software at a list price of ₹ 30,00,000 and paid ₹ 50,000 towards purchase tax which is non-refundable. In addition to this, the entity was granted a trade discount of 5% on the initial list price. X Ltd. incurred cost of ₹ 7,00,000 towards customisation of the software for its intended use. X Ltd. purchased a 5-year maintenance contract with the vendor company of ₹ 2,00,000. At what cost the intangible asset will be recognised?

7. X Limited in a business combination, purchased the net assets of Y Limited for ₹ 4,00,000 on 31st March, 20X1. The assets and liabilities position of Y Limited just before the acquisition is as follows:

Assets	**Cost (in ₹)**
Property, Plant & Equipment	1,00,000
Intangible asset 1	20,000
Intangible asset 2	50,000
Cash & Bank	1,30,000
Liabilities	
Trade payable	50,000

The fair market value of the PPE, intangible asset 1 and intangible asset 2 is available and they are ₹ 1,50,000, ₹ 30,000 and ₹ 70,000 respectively.

How would X Limited account for the net assets acquired from Y Limited?

8. X Ltd. acquired Y Ltd. on 30th April, 20X1. The purchase consideration is ₹ 50,00,000. The fair value of the tangible assets is ₹ 45,00,000. The company estimates the fair value of "in-process research projects" at ₹ 10,00,000. No other Intangible asset is acquired by X Ltd. in the transaction. Further, cost incurred by X Ltd. in relation to that research project is as follows:

(a) ₹ 5,00,000 – as research expenses

(b) ₹ 2,00,000 – to establish technological feasibility

(c) ₹ 7,00,000 – for further development cost after technological feasibility is established.

At what amount the intangible asset should be measured under Ind AS 38?

9. X Ltd. acquired a patent right of manufacturing drug from Y Ltd. In exchange X Ltd. gives its intellectual property right to Y Ltd. Current market value of the patent and intellectual property rights are ₹ 20,00,000 and ₹ 18,00,000 respectively. At what value patent right should be initially recognised in the books of X Ltd. in following two situations?

(a) X Ltd. did not pay any cash to Y Ltd.

(b) X Ltd. pays ₹ 2,00,000 to Y Ltd.

10. X Garments Ltd. spent ₹ 1,00,00,000 towards promotions for a fashion show by way of various on-road shows, contests etc.

After that event, it realised that the brand name of the entity got popular and resultantly, subsequent sales have shown a significant improvement. It is further expected that this hike will have an effect over the next 2-3 years.

How the entity should account for the above cost incurred on promoting such show?

11. An entity is developing a new production process. During 20X1-20X2, expenditure incurred was ₹ 1,000, of which ₹ 900 was incurred before 1st March, 20X2 and ₹ 100 was incurred between 1st March, 20X2 and 31st March, 20X2. The entity is able to demonstrate that at 1st March, 20X2, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be ₹ 500.

During 20X2-20X3, expenditure incurred is ₹ 2,000. At the end of 20X3, the recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be ₹ 1,900.

12. X Ltd. is engaged is developing computer software. The expenditures incurred by X Ltd. in pursuance of its development of software is given below:

(a) Paid ₹ 2,00,000 towards salaries of the program designers.

(b) Incurred ₹ 5,00,000 towards other cost of completion of program design.

(c) Incurred ₹ 2,00,000 towards cost of coding and establishing technical feasibility.

(d) Paid ₹ 7,00,000 for other direct cost after establishment of technical feasibility.

(e) Incurred ₹ 2,00,000 towards other testing costs.

(f) A focus group of other software developers was invited to a conference for the introduction of this new software. Cost of the conference aggregated to ₹ 70,000.

(g) On 15th March, 20X1, the development phase was completed and a cash flow budget was prepared.

Net profit for the year was estimated to be equal ₹ 40,00,000. How X Ltd. should account for the above mentioned cost?

13. X Ltd. has started developing a new production process in financial year 20X1-20X2. Total expenditure incurred till 30th September, 20X1, was ₹ 1,00,00,000. The expenditure on the development of the production process meets the recognition criteria on 1st July, 20X1. The records of X Ltd. show that, out of total ₹ 1,00,00,000, ₹ 70,00,000 were incurred during July to September, 20X1. X Ltd. publishes its financial results quarterly. How X Ltd. should account for the development expenditure?

14. X Ltd. decides to revalue its intangible assets on 1st April, 20X1. On the date of revaluation, the intangible assets stand at a cost of ₹ 1,00,00,000 and accumulated amortisation is ₹ 40,00,000. The intangible assets are revalued at ₹ 1,50,00,000. How should X Ltd. account for the revalued intangible assets in its books of account?

Answers

1. X Ltd. should recognise an intangible asset in respect of the consideration paid towards 'Non-Compete Fee'.

   However, amount paid for obtaining skilled staff amounting to ₹ 30,00,000 does not meet the definition of intangible asset since X Ltd. has not established any right over the resource and should be expensed. The entity has insufficient control over the expected future economic benefits arising from a team of skilled staff.

   Therefore, ₹ 50,00,000 will be separately recognised as an intangible asset, whereas amount paid for obtaining skilled staff does not meet the recognition criteria. However, since it is acquired in a business combination, it forms part of the goodwill recognised at the acquisition date.

   The value of goodwill is ₹ 1,00,00,000 (₹ 1,50,00,000 – ₹ 50,00,000).

2. The franchise rights meets the identification criterion in the definition of an intangible asset since it arises from the contractual rights. It is acquired separately and its cost can be measured reliably. In addition, X Ltd. will have future economic benefits and control over them from the franchise rights.

   X Ltd. should recognise the franchise right as intangible asset and amortise it over 10 years. Royalty as a percentage of sales paid to the franchisor would be a charge to the profit and loss in the books of the X Ltd.

3. In this situation, the entity has no legal rights to the customer relationship, but exchange transactions have taken place that evidence separability of the asset and the control that the entity is able to exercise over the asset. Therefore, the list is an intangible asset. However, the entity may not recognise the asset because the cost of generating the customer list internally cannot be distinguished from the cost of developing the business as a whole.

4. Although, without doubt the skill sets of the employees make them extremely valuable to the company, however it does not have control over them. Merely having good HR policies would not make them eligible to be recognised as an intangible asset.

5. Cost of acquisition of the telecom license can be capitalised as an intangible asset under the head Licenses, as it will lead to future economic benefits for X Ltd.

6. In accordance with Ind AS 38, the cost of a separately acquired intangible asset is its purchases price and non-refundable purchase taxes, after deducting trade discounts and rebates and any directly attributable cost of preparing the asset for its intended use.

   Therefore, the initial cost of the asset should be:

	Amount (₹)
List price	30,00,000

Less: Trade discount (5%)	(1,50,000)
	28,50,000
Non-refundable purchase tax	50,000
Customisation cost	7,00,000
Total cost	36,00,000

The maintenance contract of ₹ 2,00,000 is an expense and therefore should be taken as a prepaid expense and charged to profit and loss over a period of 5 years.

7. X Limited will account for the assets acquired from Y Limited in following manner:

Assets	**Amount (₹)**
Property, plant and equipment	1,50,000
Goodwill	70,000
Intangible asset 1	30,000
Intangible asset 2	70,000
Cash & Bank	1,30,000
Liabilities	
Trade payable	50,000

Note 1- Goodwill is the difference between fair value of net assets acquired and purchase consideration paid when is calculated as follow:

Goodwill = ₹ 4,00,000 – ₹ (1,50,000 + 70,000 + 30,000 + 1,30,000 – 50,000) = ₹ 70,000.

8. X Ltd. should initially recognise the acquired "in house research project" at its fair value i.e., ₹ 10,00,000. Research cost of ₹ 5,00,000 and cost of ₹ 2,00,000 for establishing technical feasibility should be charged to profit & loss. Costs incurred from the point of technological feasibility/asset recognition criteria until the time when development costs are incurred are capitalised.

So the intangible asset should be recognised at ₹ 17,00,000 (₹ 10,00,000 + ₹ 7,00,000).

9. If an entity is able to determine reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure cost unless the fair value of the asset received is more clearly evident.

The transaction at the fair value of the asset received adjusted for any cash received or paid. Therefore, in case (a) patent is measured at ₹ 18,00,000, in case (b) it is measured at ₹ 20,00,000 (18,00,000 + 2,00,000).

10. Expenditure of ₹ 1,00,00,000 though increased future economic benefits, but it does not result in creation of an intangible asset.

Such promotional cost should be expensed off.

11. At the end of the financial year 20X2, the production process is recognised as an intangible asset at a cost of ₹ 100 (expenditure incurred since the date when the recognition criteria were met, i.e., 1st March, 20X2). ₹ 900 expenditure incurred before 1st March, 20X2 is recognised as an expense because the recognition criteria were not met until 1st March, 20X2. This expenditure does not form part of the cost of the production process recognised in the balance sheet.

At the end of 20X3, the cost of the production process is ₹ 2,100 (₹ 100 expenditure recognised at the end of 20X2 plus ₹ 2,000 expenditure recognised in 20X3). The entity recognises an impairment loss of ₹ 200 to adjust the carrying amount of the process before impairment loss (₹ 2,100) to its recoverable amount (₹ 1,900). This impairment loss will be reversed in a subsequent period if the requirements for the reversal of an impairment loss in Ind AS 36 are met.

12. Costs incurred in creating computer software, should be charged to research & development expenses when incurred until technical feasibility/asset recognition criteria have been established for the product. Here, technical feasibility is established after completion of detailed program design.

In this case, ₹ 9,00,000 (salary cost of ₹ 2,00,000, program design cost of ₹ 5,00,000 and coding and technical feasibility cost of ₹ 2,00,000) would be recorded as expense in Profit and Loss since it belongs to research phase.

Cost incurred from the point of technical feasibility are capitalised as software costs. But the conference cost of ₹ 70,000 would be expensed off.

In this situation, direct cost after establishment of technical feasibility of ₹ 7,00,000 and testing cost of ₹ 2,00,000 will be capitalised.

The cost of software capitalised is = ₹ (7,00,000 + 2,00,000) = ₹ 9,00,000.

13. X Ltd. should recognise the intangible asset at ₹ 70,00,000 and ₹ 30,00,000 which was already recognised as an expenses in first quarter should not be capitalised.

14. The intangible assets are revalued to ₹ 1,50,00,000 on an amortised replacement cost basis, which is a 150% increase from its original cost. Thereby applying the existing ratio of accumulated depreciation to the cost the revalued gross amount would be ₹ 2,50,00,000 gross and ₹ 1,00,00,000 on amortisation.

UNIT 7 : INDIAN ACCOUNTING STANDARD 40 : INVESTMENT PROPERTY

LEARNING OUTCOMES

After studying this unit, you will be able to

- Understand the objective and scope of this standard.
- Define the terms like investment property and owner-occupied property.
- Identify and recognise an investment property.
- Measure the investment property in accordance with the standard.
- Comply with disclosure requirements.

UNIT OVERVIEW

Investment Property
Ind AS 40

- Objective and Scope
- Classification of property as investment property or owner-occupied property
- Transfers and Disposals
- Recognition and Measurement

7.1 OBJECTIVE

The objective of this standard is to prescribe the accounting treatment for property (land and/or buildings) held to earn rentals or for capital appreciation (or both). Ind AS 40 prescribes the cost model for accounting for investment property.

7.2 SCOPE

1) Ind AS 40 should be applied in the recognition, measurement and disclosure of investment property.

2) This Standard does not apply to:

   a) biological assets related to agricultural activity (see Ind AS 41, *Agriculture* and Ind AS 16 *Property, Plant and Equipment)*; and

   b) mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.

7.3 RELEVANT DEFINITIONS

The following are the key Investment Property-related definitions:

1) **Investment property** is property (land or a building—or part of a building—or both) held (by the owner or by the lessee ***as a right-of-use asset***) to earn rentals or for capital appreciation

or both, rather than for:

a) use in the production or supply of goods or services or for administrative purposes; or

b) sale in the ordinary course of business.

2) **Owner-occupied property** is property held (by the owner or by the lessee ***as a right-of-use asset***) for use in the production or supply of goods or services or for administrative purposes.

3) **Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See Ind AS 113, *Fair Value Measurement*).

4) **Cost** is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other Ind ASs, eg Ind AS 102, *Share Based Payment*.

5) **Carrying amount** is the amount at which an asset is recognised in the balance sheet.

7.4 CLASSIFICATION OF PROPERTY AS INVESTMENT PROPERTY OR OWNER-OCCUPIED PROPERTY

1) Nature of Investment property

Investment property is held to earn rentals or for capital appreciation or both. Therefore, an investment property generates cash flows largely independently of the other assets held by an entity. This distinguishes investment property from owner-occupied property.

The production or supply of goods or services (or the use of property for administrative purposes) generates cash flows that are attributable not only to property, but also to other assets used in the production or supply process. Ind AS 16 Property, Plant and Equipment applies to owner-occupied property ***and Ind AS 116 applies to owner-occupied property held by a lessee as a right-of-use asset.***

2) Examples

The following are examples of investment property:

a) land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business.

b) land held for a currently undetermined future use. (If an entity has not determined that it will use the land as owner-occupied property or for short-term sale in the ordinary course of business, the land is regarded as held for capital appreciation.)

c) a building owned by the entity ***(or a right-of-use asset relating to a building held by the entity)*** and leased out under one or more operating leases.

d) a building that is vacant but is held to be leased out under one or more operating leases.

e) property that is being constructed or developed for future use as investment property.

The following are examples of items that are not investment property and are therefore outside the scope of this Standard:

a) property intended for sale in the ordinary course of business or in the process of construction or development for such sale (see Ind AS 2, *Inventories*), for example, property acquired exclusively with a view to subsequent disposal in the near future or for development and resale.

b) owner-occupied property (see Ind AS 16 ***and Ind AS 116***), including property held for future use as owner-occupied property, property held for future development and subsequent use as owner-occupied property, property occupied by employees (whether or not the employees pay rent at market rates) and owner-occupied property awaiting disposal.

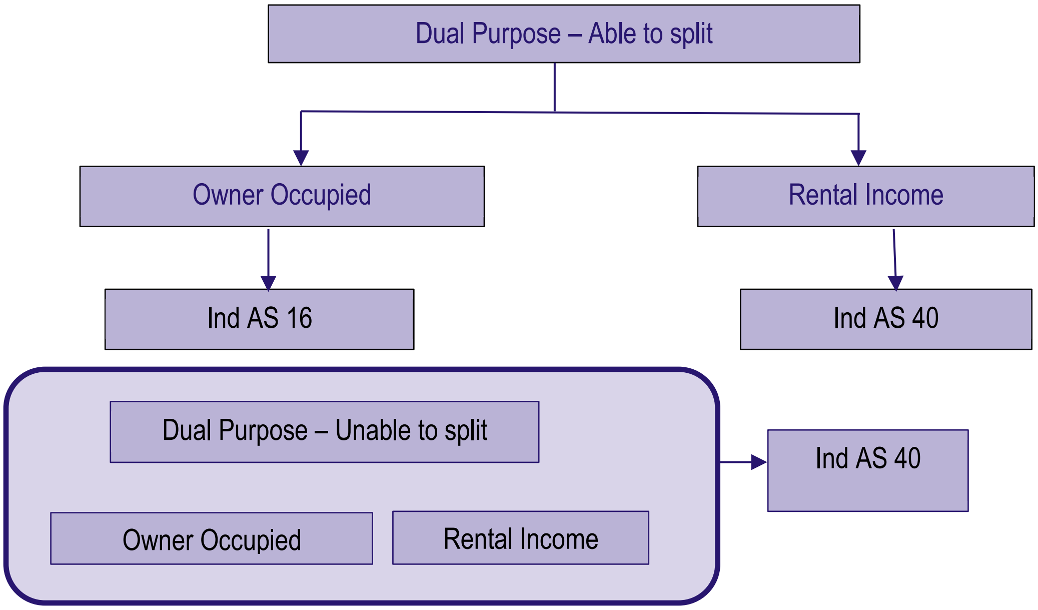
c) property leased to another entity under a finance lease.

Not Investment Property

Sale in the ordinary course of business	Owner - occupied property	Employee occupied property
Ind AS 2	**Ind AS 16**	**Ind AS 16**

3) Property held for more than one purpose

In circumstances when property is held partly for capital appreciation and/or rentals, and partly for production or supply of goods or services or for administrative purposes, the two parts are accounted for separately if they could be sold, or leased out separately under a finance lease, separately. If they could not be sold (or leased out under a finance lease) separately, the property is accounted for as an investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administrative purposes.



Example

Sun Ltd owns a building having 15 floors of which it uses 5 floors for its office; the remaining 10 floors are leased out to tenants under operating leases. According to law company could sell legal title to the 10 floors while retaining legal title to the other 5 floors.

In the given scenario, the remaining 10 floors should be classified as investment property, since they are able to split the title between the floors.

Example

Moon Ltd uses 35% of the office floor space of the building as its head office. It leases the remaining 65% to tenants, but it is unable to sell the tenant's space or to enter into finance leases related solely to it.

Therefore, the company should not classify the property as an investment property as the 35% of the floor space used by the company is significant.

Example

An entity owns a hotel, which includes a health and fitness centre, housed in a separate building that is part of the premises of the entire hotel. The owner operates the hotel and other facilities on the hotel with the exception of the health and fitness centre, which can be sold or leased out under a finance lease. The health and fitness centre will be leased to an independent operator. The entity has no further involvement in the health and fitness centre. In this scenario, management should classify the hotel and other facilities as property, plant and equipment and the health and fitness centre as investment property.

If the health and fitness centre could not be sold or leased out separately on a finance lease, then because the owner-occupied portion is not insignificant, the whole property would be treated as an owner-occupied property.

4) Ancillary services

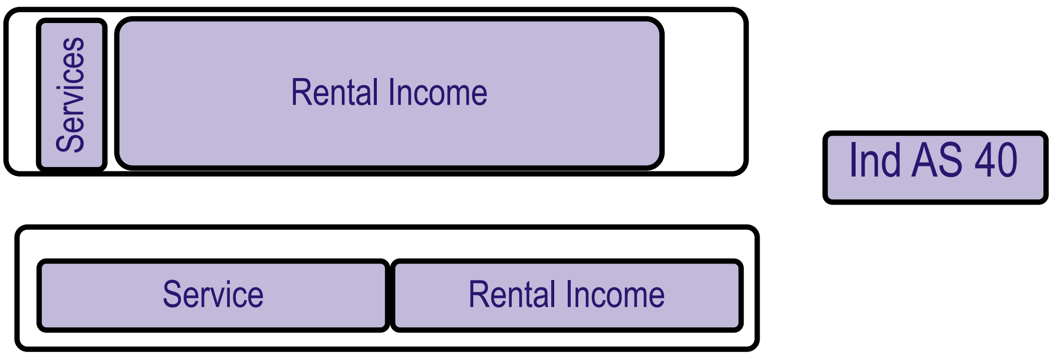
In some cases, an entity provides ancillary services to the occupants of a property it holds. An entity treats such a property as investment property if the services are insignificant to the arrangement as a whole. An example is when the owner of an office building provides security and maintenance services to the lessees who occupy the building.

In other cases, the services provided are significant. For example, if an entity owns and manages a hotel, services provided to guests are significant to the arrangement as a whole. Therefore, an owner-managed hotel is owner-occupied property, rather than investment property.

Example

The owner of an office building provides security and maintenance services to the lessees who occupy the building. In such a case, since the services provided are insignificant, the property would be treated as an investment property.

If an entity owns and manages a hotel, services provided to guests are significant to the arrangement as a whole. In such case, an owner-managed hotel is owner-occupied property, rather than investment property.



It may be difficult to determine whether ancillary services are so significant that a property does not qualify as investment property. For example, the owner of a hotel sometimes transfers some responsibilities to third parties under a management contract. The terms of such contracts vary widely. At one end of the spectrum, the owner's position may, in substance, be that of a passive investor. At the other end of the spectrum, the owner may simply have outsourced day-to-day functions while retaining significant exposure to variation in the cash flows generated by the operations of the hotel.

Judgement is needed to determine whether a property qualifies as investment property. Judgement is also required to determine whether the acquisition of Investment Property is the acquisition of an asset or a group of assets or a business combination within the scope of Ind AS 103, Business Combinations.

5) Property leased to other group members

In some cases, an entity owns property that is leased to, and occupied by, its parent or another subsidiary. The property does not qualify as investment property in the consolidated financial statements, because the property is owner-occupied from the perspective of the group. However, from the perspective of the entity that owns it, the property is investment property if it meets the definition of Investment Property. Therefore, the lessor treats the property as investment property in its individual financial statements.

Tabular summarisation

S.No.	Property	Does it meet definition of Investment Property	Which Ind AS is Applicable
1.	Owned by a Company and leased out under an Operating Lease	Yes	Ind AS 40
2.	Held as a right-to-use asset and Leased out under an Operating Lease	Yes	Ind AS 40
3.	Held as a right-to-use asset and Leased out under Finance Lease	No	Ind AS 116
4.	Property acquired with a view for development and resale	No	Ind AS 2
5.	Property partly owner occupied and partly leased out under Operating Lease	Depends	Ind AS 16 Ind AS 40
6.	Land held for currently undetermined use	Yes	Ind AS 40
7.	Property occupied by Employees paying rent at less than market rate	No	Ind AS 16
8.	Investment Property held for sale	No	Ind AS 105
9.	Existing Investment Property that is being redeveloped for continued use as Investment Property	Yes	Ind AS 40

7.5 RECOGNITION

1) General principle

An owned investment property shall be recognised as an asset when, and only when:

a) it is probable that the future economic benefits that are associated with the investment property will flow to the entity; and

b) the cost of the investment property can be measured reliably.

This general principle is used to consider whether capitalisation is appropriate both in respect of the cost incurred initially to acquire or construct an owned investment property and costs incurred subsequently to add to, replace part of, or service a property.

An investment property held by a lessee as a right-of-use asset shall be recognised in accordance with Ind AS 116.

2) Subsequent costs

Under the recognition principle set out above, an entity does not recognise in the carrying amount of an investment property the costs of the day-to-day servicing of such a property and costs incurred to replace parts of the original property being recognised in the investment property if they meet the recognition criteria.

When the cost of replacement parts is capitalised, the carrying amount of the replaced parts is derecognised.

Illustration 1

X Limited owns a building which is used to earn rentals. The building has a carrying amount of ₹ 50,00,000. X Limited recently replaced interior walls of the building and the cost of new interior walls is ₹ 5,00,000. The original walls have a carrying amount of ₹ 1,00,000. How X Limited should account for the above costs?

Solution

Under the recognition principle, an entity recognises in the carrying amount of an investment property the cost of replacing part of an existing investment property at the time that cost is incurred if the recognition criteria are met and the carrying amount of those parts that are replaced is derecognised.

So, X Limited should add the cost of new walls and remove the carrying amount of old walls. The new carrying amount of the building = ₹ 50,00,000 + ₹ 5,00,000 – ₹ 1,00,000 = ₹ 54,00,000.

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7.6 MEASUREMENT AT RECOGNITION

1) Measurement at recognition - general

An ***owned*** investment property should be measured initially at its cost. Transaction costs are included in the initial measurement.

The cost of a purchased investment property comprises its purchase price and any directly attributable expenditure (e.g. professional fees for legal services, property transfer taxes and other transaction costs).

The cost of an investment property is not increased by:

a) start-up costs (unless they are necessary to bring the property to the condition necessary for it to be capable of operating in the manner intended by management),

b) operating losses incurred before the investment property achieves the planned level of occupancy, or

c) abnormal amounts of wasted material, labour or other resources incurred in constructing or developing the property.

2) Deferred payments

If payment for an investment property is deferred, its cost is the cash price equivalent. The difference between this amount and the total payments is recognised as interest expense over the period of credit.

3) Investment property acquired through exchange of another asset

One or more investment properties may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The cost of such an investment property is measured at fair value unless:

a) the exchange transaction lacks commercial substance or

b) the fair value of neither the asset received nor the asset given up is reliably measurable.

The acquired asset is measured in this way even if an entity cannot immediately derecognise the asset given up. If the acquired asset is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred, or

b) the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange, and

c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

The fair value of an asset is reliably measurable if:

a) the variability in the range of reasonable fair value measurements is not significant for that asset or

b) the probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value.

If the entity is able to measure reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure cost unless the fair value of the asset received is more clearly evident.

An investment property held by a lessee as a right-of-use asset shall be measured initially at its cost in accordance with Ind AS 116.

Example:

Sun Ltd acquired a building in exchange of a warehouse whose fair value is ₹ 5,00,000 and payment of cash is ₹ 2,00,000. The fair value of the building received by the Company is ₹ 8,00,000. The company decided to keep that building for rental purposes.

The Building is acquired with the purpose to earn rentals. Hence, it is a case of Investment Property acquired in exchange for a combination of monetary and non-monetary asset.

Therefore,

Journal entry at the time of acquisition is :

Investment Property (Building) (5,00,000 + 2,00,000)	.Dr	7,00,000	
To Cash			2,00,000
To PPE (Property, Plant and Equipment) i.e. Warehouse			5,00,000

Illustration 2

X Limited purchased a building for ₹ 30,00,000 in 1st May, 20X1. The purchase price was funded by a loan. Property transfer taxes and direct legal costs of ₹ 1,00,000 and ₹ 20,000 respectively were incurred in acquiring the building. In 20X1-20X2, X Limited redeveloped the building into retail shops for rent under operating leases to independent third parties. Expenditures on redevelopment were:

₹ 2,00,000 planning permission.

₹ 7,00,000 construction costs (including ₹ 40,000 refundable purchases taxes).

The redevelopment was completed and the retail shops were ready for rental on 2nd September, 20X1.

What is the cost of building at initial recognition?

Solution

The cost of a purchased investment property comprises its purchase price and any direct attributable expenditure.

So, the cost of the building = ₹ (30,00,000 +1,00,000 + 20,000 + 2,00,000 + 7,00,000 - 40,000) = ₹ 39,80,000.

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Illustration 3

X Limited purchased a land worth of ₹ 1,00,00,000. It has option either to pay full amount at the time of purchases or pay for it over two years for a total cost of ₹ 1,20,00,000. What should be the cost of the building under both the payment methods?

Solution

Using either payment method, the cost will be ₹ 1,00,00,00. If the second payment option is used, ₹ 20,00,000 will be treated as interest expenses over the period of credit i.e., 2 years.

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7.7 MEASUREMENT AFTER RECOGNITION

1) Accounting Policy

After initial recognition, an entity shall measure investment property:

(a) in accordance with Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations, if it meets the criteria to be classified as held for sale (or is included in a disposal group that is classified as held for sale);

(b) in accordance with Ind AS 116 if it is held by a lessee as a right-of-use asset and is not held for sale in accordance with Ind AS 105; and

(c) in accordance with the requirements in Ind AS 16 for cost model in all other cases.

Entities are required to measure the fair value of investment property, for the purpose of disclosure even though they are required to follow the cost model. An entity is encouraged, but not required, to measure the fair value of investment property on the basis of a valuation by an independent valuer who holds a recognised and relevant professional qualification and has recent experience in the location and category of the investment property being valued.

2) Fair Value Measurement

While measuring the fair value of investment property in accordance with Ind AS 113, an entity should ensure that the fair value reflects, among other things, rental income from current leases and other assumptions that market participants would use when pricing investment property under current market conditions.

When a lessee measures fair value of an investment property that is held as a right-of-use asset, it shall measure the right-of-asset, and not the underlying property at fair value.

3) Inability to measure fair value reliably

There is a rebuttable presumption that an entity can reliably measure the fair value of an investment property on a continuing basis. But in exceptional cases, when an entity first acquired (or when an existing property first becomes investment property after a change in use), there may be clear evidence that the fair value of the investment property is not reliably measurable on a continuing basis. This arises when, and only when, the market for comparable properties is inactive (e.g. there are few recent transactions, price quotations are not current or observed transaction prices indicate that the seller was forced to sell) and alternative reliable measurements of fair value (for example, based on discounted cash flow projections) are not available.

Above exception is available only when the investment property is first recognised as such. If an entity has previously measured the fair value of an investment property, it should continue to measure the fair value of that property until disposal (or until the property becomes owner-occupied property or the entity begins to develop the property for subsequent sale in the ordinary course of business) even if comparable market transactions become less frequent or market prices become less readily available.

If an entity determines that the fair value of an investment property (other than an investment property under construction) is not reliably measurable on a continuing basis, the entity should make the disclosures as prescribed under Ind AS 40.

In the exceptional cases when an entity is compelled, for the reason given above to make the disclosures, it should determine the fair value of all its other investment property, including investment property under construction. In these cases, although an entity may make the disclosures as required for one investment property, the entity should continue to determine the fair value of each of the remaining properties for disclosure as required.

4) Investment property in the course of construction

If an entity determines that the fair value of an investment property under construction is not reliably measurable but expects the fair value of the property to be reliably measurable when construction is complete, it should measure the fair value of that investment property either when its fair value becomes reliably measurable or construction is completed (whichever is earlier).

Once an entity becomes able to measure reliably the fair value of an investment property under construction for which the fair value was not previously measured, it should measure the fair value of that property.

Once construction of that property is complete, it is presumed that fair value can be measured reliably. If this is not the case, the entity should make the disclosures as required by Ind AS 40.

The presumption that the fair value of investment property under construction can be measured reliably can be rebutted only on initial recognition. An entity that has measured the fair value of an item of investment property under construction may not conclude that the fair value of the completed investment property cannot be measured reliably.

7.8 TRANSFERS

1) An entity shall transfer a property to, or from, investment property when, and only when, there is a change in use. A change in use occurs when the property meets, or ceases to meet, the definition of investment property and there is evidence of the change in use. In isolation, a change in management's intentions for the use of a property does not provide evidence of a change in use. Examples of evidence of a change in use include:

   a) commencement of owner-occupation, or of development with a view to owner-occupation, for a transfer from investment property to owner-occupied property;

      Ind AS 40 ➡ Ind AS 16

   b) commencement of development with a view to sale, for a transfer from investment property to inventories;

      Ind AS 40 ➡ Ind AS 2

   c) end of owner-occupation, for a transfer from owner-occupied property to investment property; or

      Ind AS 16 ➡ Ind AS 40

   d) inception of an operating lease to another party, for a transfer from inventories to investment property.

      Ind AS 2 ➡ Ind AS 40

2) When an entity decides to dispose of an investment property without development, it continues to treat the property as an investment property until it is derecognised (eliminated from the balance sheet) and does not reclassify it as inventory. Similarly, if an entity begins to redevelop an existing investment property for continued future use as investment property, the property remains an investment property and is not reclassified as owner-occupied property during the redevelopment.

3) 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.

Illustration 4

Moon Ltd has purchased a building on 1st April, 20X1 at a cost of ₹ 10 million. The building was used as a factory by the Moon Ltd and was measured under cost model. The expected useful life of the building is estimated to be 10 years. Due to decline in demand of the product, the Company does not need the factory anymore and has rented out the building to a third party from

1st April, 20X5. On this date the fair value of the building is ₹ 8 million. Moon ltd uses cost model for accounting of its investment property.

Solution

	(₹ Million)
Carrying amount of the building after depreciation of 4 years (10-10/10 x 4).	6
The company has applied cost model under Ind AS 16 till now.	
There is no impairment as the fair value is greater than the carrying amount of building.	
Revaluation Surplus credited to Other Comprehensive Income (not applicable since cost model is used under Ind AS 16)	---
Building initially recognised as Investment Property (Cost model Ind AS 40)	6

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7.9 DISPOSALS

1) An investment property should be derecognised (eliminated from the balance sheet)

   a. on disposal or

   b. when the investment property is permanently withdrawn from use and no future economic benefits are expected from its disposal.

2) The disposal of an investment property may be achieved by:

   a. sale or

   b. entering into a finance lease.

3) The date of disposal for investment property ***that is sold*** is the date the recipient obtains control of the investment property in accordance with the requirements for determining when a performance obligation is satisfied in Ind AS 115. Ind AS 116 applies to a disposal effected by entering into a finance lease and to a sale and leaseback.

4) Gains or losses arising from the retirement or disposal of investment property should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and shall be recognised in profit or loss (unless Ind AS 116 requires otherwise on a sale and leaseback) in the period of the retirement or disposal.

5) The amount of consideration to be included in the gain or loss arising from the derecognition of an investment property is determined in accordance with the requirements for determining the transaction price as per Ind AS 115. Subsequent changes to the estimated amount of the consideration included in the gain or loss shall be accounted for in accordance with the requirements for changes in the transaction price in Ind AS 115.

6) An entity applies Ind AS 37 or other Standards, as appropriate, to any liabilities that it retains after disposal of an investment property.

7) Compensation from third parties for investment property that was impaired, lost or given up shall be recognised in profit or loss when the compensation becomes receivable.

Example:

Sun Ltd, an aeronautics company is having a building which is given on an operating lease. The book value of such building in the books is ₹ 2,00,000.

Case -A

Pluto Ltd. offers to buy the building at ₹ 4,00,000.

Bank	Dr	4,00,000	
To Investment Property			2,00,000
To Gain on disposal			2,00,000

Case- B

Pluto Ltd. offers to take the building on finance lease for 10 years at a lease rental of ₹ 80,000 p.a. The present value of minimum lease payments is ₹ 3,20,000.

Lease Receivable	Dr	3,20,000	
To Investment Property			2,00,000
To Gain on Disposal			1,20,000

7.10 DISCLOSURE

The disclosures below apply in addition to those in Ind AS 116. In accordance with Ind AS 116, the owner of an investment property provides lessors' disclosures about leases into which it has entered. A lessee that holds an investment property as a right-of-use asset provides lessees' disclosures as required by Ind AS 116 and lessors' disclosures as required by Ind AS 116 for any operating leases into which it has entered.

An entity should disclose:

1) its accounting policy for measurement of investment property.

2) the criteria it uses to distinguish investment property from owner-occupied property and from property held for sale in the ordinary course of business.

3) the extent to which the fair value of investment property (as measured for disclosed in the financial statements) is based on a valuation by an independent valuer who holds a recognised and relevant professional qualification and has recent experience in the location and category of the investment property being valued. If there has been no such valuation, that fact shall be disclosed.

4) the amounts recognised in profit or loss for:

   a) rental income from investment property;

   b) direct operating expenses (including repairs and maintenance) arising from investment property that generated rental income during the period; and

   c) direct operating expenses (including repairs and maintenance) arising from investment property that did not generate rental income during the period.

5) the existence and amounts of restrictions on the realisability of investment property or the remittance of income and proceeds of disposal.

6) contractual obligations to purchase, construct or develop investment property or for repairs, maintenance or enhancements.

7) In addition to the general disclosures required above, an entity is required to disclose:

   a) the depreciation methods used;

   b) the useful lives or the depreciation rates used;

   c) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period;

8) An entity is also required to provide a reconciliation of the carrying amount of investment property at the beginning and end of the period, showing the following:

   a) additions, disclosing separately those additions resulting from acquisitions and those resulting from subsequent expenditure recognised as an asset;

   b) additions resulting from acquisitions through business combinations;

   c) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with Ind AS 105 and other disposals;

   d) depreciation;

   e) the amount of impairment losses recognised, and the amount of impairment losses reversed, during the period in accordance with Ind AS 36;

   f) the net exchange differences arising on the translation of the financial statements into a different presentation currency, and on translation of a foreign operation into the presentation currency of the reporting entity;

   g) transfers to and from inventories and owner-occupied property; and

   h) other changes.

9) An entity is also required to disclose the fair value of investment property. In the exceptional cases when an entity cannot measure the fair value of the investment property reliably, it should disclose:

   a) a description of the investment property;

   b) an explanation of why fair value cannot be measured reliably; and

   c) if possible, the range of estimates within which fair value is highly likely to lie.

TEST YOUR KNOWLEDGE

Questions

1. On 1st April, 20X1 an entity acquired an investment property (building) for ₹ 40,00,000. Management estimates the useful life of the building as 20 years measured from the date of acquisition. The residual value of the building is ₹ 2,00,000. Management believes that the straight-line depreciation method reflects the pattern in which it expects to consume the building's future economic benefits. What is the carrying amount of the building on 31st March, 20X2?

2. X Limited has an investment property (building) which is carried in Balance Sheet on 31st March, 20X1 at ₹ 15,00,000. During the year X Limited has stopped letting out the building and used it as its office premise. On 31st March, 20X1, management estimates the recoverable amount of the building as ₹ 10,00,000 and its remaining useful life as 20 years and residual value is nil. How should X Limited account for the above investment property as on 31st March, 20X1?

3. In financial year 20X1-20X2, X Limited incurred the following expenditure in acquiring property consisting of 6 identical houses each with separate legal title including the land on which it is built.

   The expenditure incurred on various dates is given below:

   On 1st April, 20X1 - Purchase cost of the property ₹ 1,80,00,000.

   On 1st April, 20X1 – Non-refundable transfer taxes ₹ 20,00,000 (not included in the purchase cost).

   On 2nd April, 20X1- Legal cost related to property acquisition ₹ 5,00,000.

   On 6th April, 20X1- Advertisement campaign to attract tenants ₹ 3,00,000.

   On 8th April, 20X1 - Opening ceremony function for starting business ₹ 1,50,000.

   Throughout 20X1-20X2, incurred ₹ 1,00,000 towards day-to-day repair maintenance and other administrative expenses.

   X Limited uses one of the six houses for office and accommodation of its few staffs. The other five houses are rented to various independent third parties.

   How X Limited will account for all the above mentioned expenses in the books of account?

Answers

1. Cost of the asset is ₹ 40,00,000.

   Depreciable amount = Cost less Residual value = ₹ (40,00,000 - 2,00,000) = ₹ 38,00,000

Depreciation for the year = Depreciable amount/useful life

= ₹ 38,00,000/20

= ₹ 1,90,000.

Carrying amount = Cost less accumulated depreciation

= ₹ (40,00,000 - 1,90,000) = ₹ 38,10,000.

2. At 31st March, 20X1, X Limited must transfer the property from investment property to property, plant and equipment since there is a change in use of the said building. The transfer should be made at its carrying amount i.e., ₹ 15,00,000. Since recoverable amount of the property as on 31st March, 20X1 is ₹ 10,00,000, impairment loss ₹ 5,00,000 should be recognised in the Statement of Profit and Loss.

The entity must disclose the reclassification.

From April, 20X1, X Limited will depreciate the building over its remaining useful life of 20 years.

3. The cost of the property = ₹ (1,80,00,000 + 20,00,000 + 5,00,000) = ₹ 2,05,00,000.

Since five houses out of six are being rented, so 5/6th of the property cost will be accounted for as an investment property and 1/6th of the property cost will be accounted for as owner occupied property.

Cost of the investment property = ₹ 2,05,00,000 x 5/6 = ₹ 1,70,83,333

Cost of the owner occupied property = ₹ (2,05,00,000 - 1,70,83,333) = ₹ 34,16,667. All other costs, i.e., advertisement expenses, ceremony expenses and repair maintenance expenses will be expensed off as and when incurred.

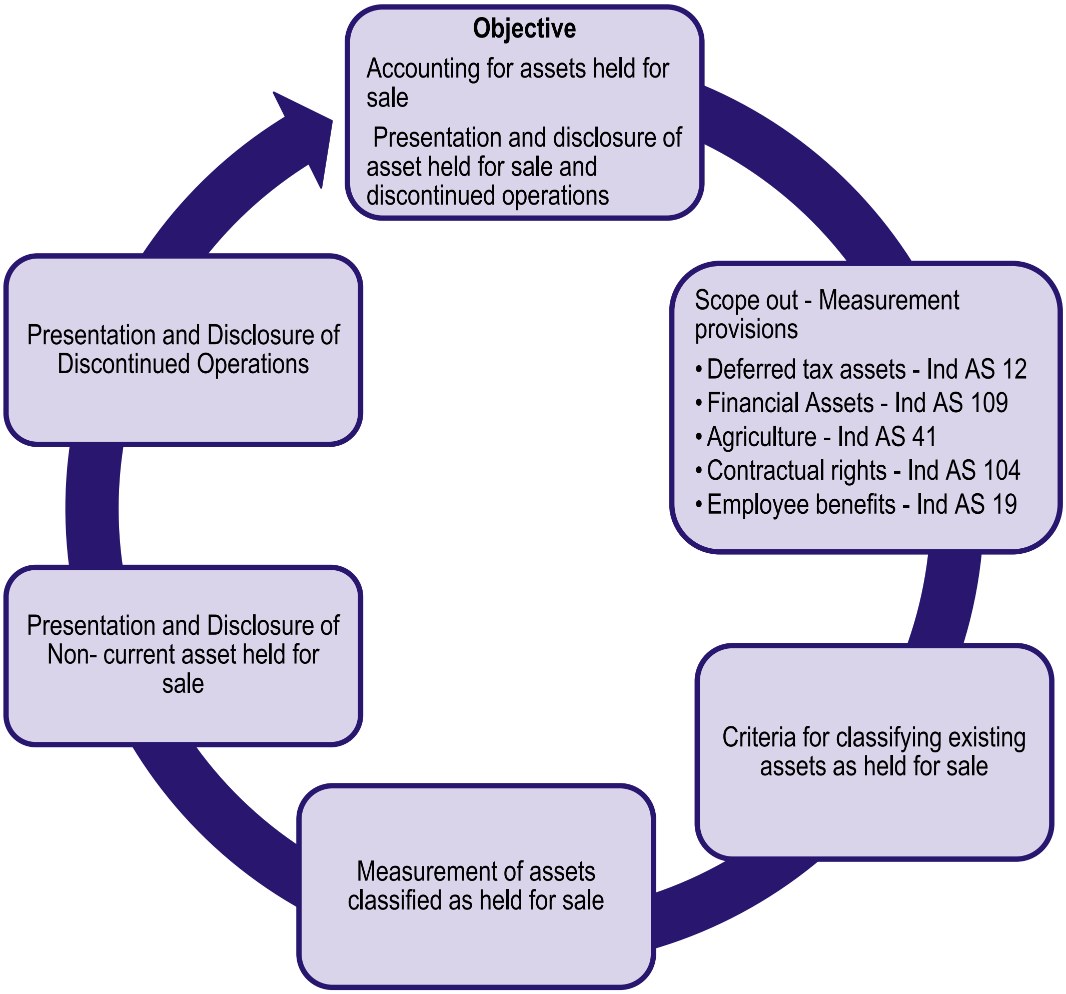
UNIT 8 : INDIAN ACCOUNTING STANDARD 105 : NON-CURRENT ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS

LEARNING OUTCOMES

After studying this unit, you will be able to

- Understand the objective and scope of this standard
- Define the terms non-current asset, disposal group, cash generating unit and discontinued operation
- Examine the criteria for classifying existing assets as held for sale
- Measure non-current assets (or disposal group) classified as held for sale
- Present and disclose non-current assets (or disposal group) classified as held for sale
- Present and disclose discontinued operations as per the standard.

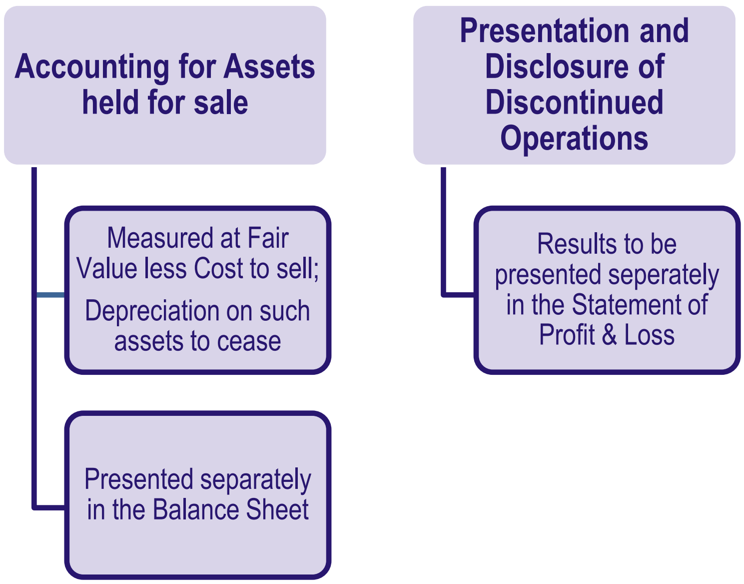
UNIT OVERVIEW



8.1 OBJECTIVE

- Non-Current assets held for sale are presented separately from other assets in the Balance Sheet as their classification will change and the value will be principally recovered through sale transaction rather than through continuous use in operations of the entity. This standard specifies the accounting for assets held for sale.
- Results of Discontinuing Operations should be separately presented in the Statement of Profit and loss as it affects the ability of the entity to generate future cash flows. This standard specifies the presentation and disclosure of discontinued operations.

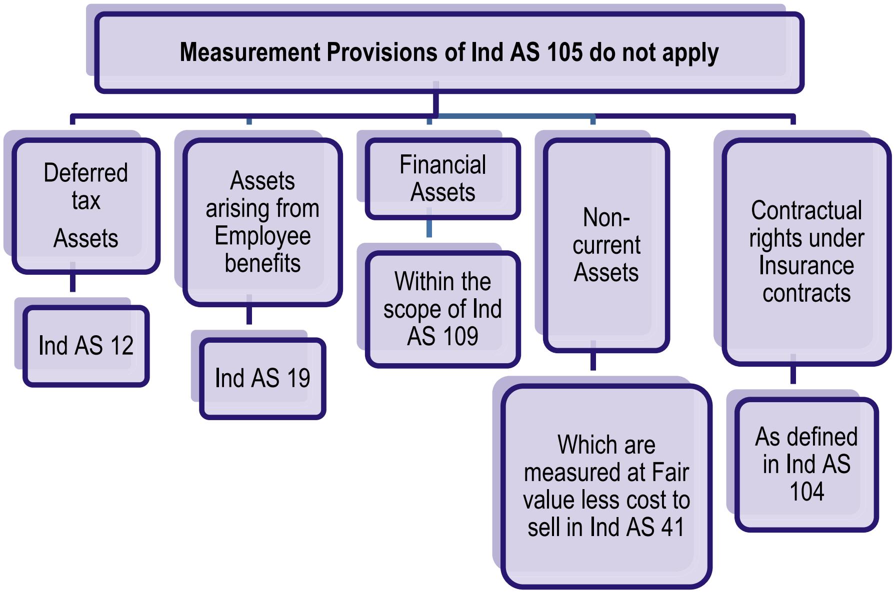
Hence, two core objectives of the standard is as follows:



8.2 SCOPE

- The classification and presentation requirements of this Ind AS apply to all recognised non-current assets and to all disposal groups of an entity.
- The measurement requirements of this Ind AS also apply to all recognised non-current assets and to all disposal groups of an entity except few exceptions mentioned below.
- Assets classified as non-current in accordance with Ind AS 1, Presentation of Financial Statements, shall not be reclassified as current assets until they meet the criteria to be classified as held for sale in accordance with this Ind AS.

- The classification, presentation and measurement requirements in this Ind AS applicable to a non-current asset (or disposal group) that is classified as held for sale apply also to a non-current asset (or disposal group) that is classified as held for distribution to owners acting in their capacity as owners.
- The measurement provisions of this Ind AS do not apply to the following assets (which are covered by the Ind ASs listed either as individual assets or as part of a disposal group):



- Disposal groups may include both scoped-in and scoped-out non-current assets. If a disposal group includes any scoped-in non-current asset(s), the measurement requirements of this Ind AS apply to the group as a whole, so that the group is measured at the lower of its carrying amount and fair value less costs to sell.

8.3 RELEVANT DEFINITIONS

The following are the key terms used in this standard:

- **Non-current assets** are assets that do not meet the definition of current assets.
- **Current asset** An entity classifies an asset as current when:

  (a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;

  (b) it holds the asset primarily for the purpose of trading;

  (c) it expects to realise the asset within twelve months after the reporting period; or

  (d) the asset is cash or a cash equivalent (as defined in Ind AS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

- **Disposal group** is a group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. A disposal group may be a group of *cash-generating units*, a single cash-generating unit, or part of a cash-generating unit.
- **Cash-generating unit is a** smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.
- **Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (Ind AS 113)
- **Costs to sell** are the incremental costs directly attributable to the disposal of an asset (or disposal group), excluding finance costs and income tax expense.
- A **discontinued operation** is a component of an entity that either has been disposed of or is classified as held for sale and:

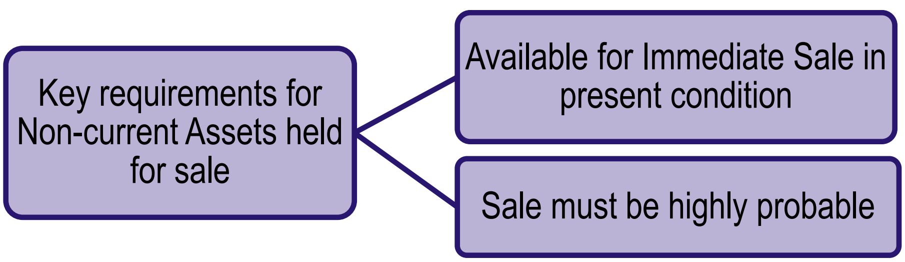
  (a) represents a separate major line of business or geographical area of operations; or

  (b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations; or

  (c) is a subsidiary acquired exclusively with a view to resale.
- A **component of an entity comprises o**perations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.
- **Highly Probable** Significantly more likely than probable. (Probable means more likely than not)

8.4 CLASSIFICATION OF NON-CURRENT ASSETS (OR DISPOSAL GROUPS) AS HELD FOR SALE OR AS HELD FOR DISTRIBUTION TO OWNERS

An entity is required to classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.



Asset must be available for immediate sale in its present condition and Sale must be highly probable are the two key requirements to classify a non-current asset as held for sale.

8.4.1 Available for Immediate Sale

The asset (or disposal group) must be available for **immediate sale** in its **present condition**. The terms that are usual and customary for sale of similar assets (or disposal group) doesn't disqualify to being classified as held for sale.

However they will not be considered as available for immediate sale if they continue to be vital for the entity's ongoing operations or being refurbished to enhance their value. Thus, an asset (or disposal group) cannot be classified as a non-current asset (or disposal group) held for sale, if the entity intends to sell it in a **distant future**.

Examples- Available for Immediate Sale

1. A property being used as a headquarters by the entity needs to be vacated before it can be sold. The time required to vacate the building is usual and customary for sale of such assets. Hence the criteria for classification as held for sale would be met.
2. In above example, if property can be vacated only after a replacement is available then this may indicate that the property is not available for immediate sale, but only after the replacement becomes available.
3. An entity can't classify a manufacturing facility as held for sale if prior to selling the facility it needs to clear a backlog of uncompleted order.
4. In above example, if entity intends to sell the manufacturing facility along with the uncompleted orders it can be classified as held for sale.
5. An entity plans to renovate some of its property to increase its value prior to selling it to a third party. The entity is already searching for a buyer at current market values. But due to the plans to renovate the property prior to sale, the property may not be meeting condition of available for immediate sale.
6. A company has put a property on the market and expects that all the conditions of classification as held for sale is meeting. Any buyer will undertake searches and valuations before making an offer and exchanging contracts : Such conditions are normal for properties and any delays that might arise from such legal processes do not preclude the property from being classified as held for sale.

8.4.2 Sale must be highly probable

This Standard defines 'highly probable' as 'significantly more likely than probable' where probable means more likely than not.

Ind AS 105 prescribes following five conditions to be satisfied for the sale to qualify as highly probable:

1. The appropriate level of management must be committed to a plan to sell the asset (or disposal group).

2. An active programme to trace a buyer and complete the selling plan must have been initiated.

3. The asset (or diposal group) must be marketed for sale at a price that is reasonable in relation to its current fair value.

4. The sale transaction is expected to be completed within one year from the date of classification.

5. Significant changes to or withdrawal from the plan to sell the asset are unlikely.

8.4.3 Other Key Points

8.4.3.1 Loss of Control in Subsidiary

An entity which has committed to a sale plan which involves loss of control of subsidiary shall classify all the assets and liabilities of that subsidiary as held for sale when the criteria set out above is met, regardless of whether the entity will retain a non-controlling interest in its former subsidiary after the sale.

8.4.3.2 Exception to the period of One year

An entity can still classify an asset (or disposal group) as held for sale, even if the timeframe of one year to conclude the sale transaction has lapsed. For this:

(i) the delay must have been caused by the events or circumstances which are beyond the control of the entity; and

(ii) there must be sufficient evidences that the entity is still committed to it selling plan.

Example

An entity is committed to its selling plan of a manufacturing facility in its present condition and so classifies it as held for sale. After a firm purchase commitment, the buyer's inspection identifies environmental damages not previously known to exist. The entity is required by the buyer to make good the damage, which will extend the timeframe of one year to complete the sale within one year. However, the entity has initiated actions to make good the damage and satisfactory rectification is highly probable. In this situation exception to one year requirement will met.

8.4.3.3 Sale includes exchange

Sale transaction includes exchange of non-current assets for other non-current assets when the exchange has commercial substance in accordance of Ind AS 16 Property, Plant and Equipment.

8.4.3.4 Asset acquired exclusively with a view to subsequent disposal

When an entity acquires a non-current asset (or disposal group) exclusively with a view to its subsequent disposal, the non-current asset (or disposal group) is classified as held for sale at the acquisition date. This standard provides a short period (usually three months) to meet the classification criteria that don't met at the acquisition except requirement of one year.

Example:

An entity has acquired a building exclusively with a view of its subsequent disposal. The management is highly confident that the property can be sold in one year. The property requires refurbishing it to enhance its value which is highly probable to be completed in less than a period of three months. The building will be classified as held for sale on the date of acquisition itself even though it is not immediately available for sale.

8.4.3.5 Criteria met after reporting period

If the criteria of held for sale are met after the reporting period but before the date of authorisation the financial statements, a non-current asset should not classify as held for sale. However, when those criteria are met after the reporting period but before the approval of the financial statements for issue, the entity shall disclose the information specified in paragraph 41(a), (b) and (d) in the notes.

8.4.3.6 Classification as held for distribution

An entity shall classify a non-current asset (or disposal group) as held for distribution to its owner on a parallel line as discussed above required for classification as held for sale.

8.4.3.7 Non-current assets to be abandoned

Non-current assets (or disposal group) that need to be abandoned will not qualify to classify as held for sale because their carrying amount will be principally recovered through continuing use in the entity's operation rather through the sale. If however, the disposal group to be abandoned meets the criteria as prescribed in Ind AS 105 to be classified as a discontinued operation, then the disclosure regarding discontinued operation must be presented.

Non-current assets (or disposal groups) to be abandoned include non-current assets (or disposal groups) that are to be used to the end of their economic life and non-current assets (or disposal groups) that are to be closed rather than sold.

Example:

Entity ceases to use a manufacturing plant because demand has declined. However, the plant is maintained in a workable condition and it is expected to be brought back into use in future when demand picks up.

It is neither to be treated as abandoned asset nor as held for sale because its carrying amount will be principally recovered through continuous use, therefore the entity will not stop charging depreciation or treat it as held for sale. This is because its carrying amount will be recovered principally through continuing use to the end of its economic life.

8.5 MEASUREMENT OF NON-CURRENT ASSETS (OR DISPOSAL GROUPS) CLASSIFIED AS HELD FOR SALE

8.5.1 Measurement at the lower of carrying amount and fair value less cost to sell

- An entity should measure a non-current asset (or disposal group) classified as held for sale at the **lower** of its **carrying amount** and **fair value less costs to sell**.
- If a newly acquired asset (or disposal group) meets the criteria to be classified as held for sale, it will be measured on initial recognition at the lower of its carrying amount had it not been so classified (for example, cost) and fair value less costs to sell. Hence, if the asset (or disposal group) is acquired as part of a business combination, it will be measured at fair value less costs to sell.
- Immediately **before the initial classification** of the asset (or disposal group) as held for sale, the carrying amounts of the asset (or all the assets and liabilities in the group) is measured in accordance with **applicable Ind AS**.
- On subsequent remeasurement of a disposal group, the carrying amounts of any assets and liabilities that are not within the scope of the measurement requirements of this Ind AS, but are included in a disposal group classified as held for sale, should be remeasured in accordance with applicable Ind Ass before the fair value less costs to sell of the disposal group is remeasured.
- Depreciation and amortization shall be immediately stopped from the moment the asset has been classified as held for sale.

- Interest and other expenses attributable to the liabilities of a disposal group classified as held for sale shall continue to be recognised.
- When the sale is expected to occur beyond one year, the entity should measure the costs to sell at their present value. Any increase in the present value of the costs to sell that arises from the passage of time shall be presented in profit or loss as a financing cost.
- Non-current asset (or disposal group) classified as held for distribution are also measured on same line as non-current asset (or disposal group) classified as held for sale.

Illustration 1 - Measurement prior to classification as held for sale

An item of property, plant and equipment that is measured on the cost basis should be measured in accordance with Ind AS 16.

Entity ABC owns an item of property and it was stated at the following amounts in its last financial statements:

31st December, 20X1	***₹***
Cost	*12,00,000*
Depreciation	*(6,00,000)*
Net book value	*6,00,000*

The asset is depreciated at an annual rate of 10% ie. ₹ 1,20,000 p.a.

During July, 20X2, entity ABC decides to sell the asset and on 1st August it meets the conditions to be classified as held for sale. Analyse.

Solution

At 31st July, entity ABC should ensure that the asset is measured in accordance with Ind AS 16. It should be depreciated by further ₹ 70,000 (₹1,20,000 x 7/12) and should be carried at ₹ 5,30,000 before it is measured in accordance with Ind AS 105.

Note: From the date the asset is classified as held for sale no further depreciation will be charged.

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Example - Classification as held for sale

A ltd acquired a property for ₹ 2,00,000. After few years the cumulative depreciation on the property is of ₹ 80,000 has been recognised and subsequently the property is classified as held for sale under Ind AS 105.

At the time of classification as held for sale it will be measured at lower of its carrying amount which is ₹ 1,20,000 (2,00,000 – 80,000) and fair value less costs to sell as estimated at ₹ 1,00,000.

Accordingly, there is a write-down on initial classification of property as held for sale and accordingly the property is carried at ₹ 1,00,000. A loss of ₹ 20,000 is recognised in profit or loss.

On next reporting date, the property's fair value less costs to sell is estimated at ₹ 85,000. Accordingly, a loss of ₹ 15,000 is recognised in profit or loss and the property is carried at ₹ 85,000.

Subsequently, the property is sold for ₹ 90,000. A gain of ₹ 5,000 will be recognised.

8.5.2 Recognition of impairment losses and reversals

- An entity should recognise an impairment loss for any initial or subsequent write-down of the asset (or disposal group) to fair value less costs to sell, to the extent that it has not been recognised in accordance with above.
- An entity should recognise a gain for any subsequent increase in fair value less costs to sell of an asset, but not in excess of the cumulative impairment loss that has been recognised either in accordance with this Ind AS or previously in accordance with Ind AS 36, *Impairment of Assets*.
- An entity should recognise a gain for any subsequent increase in fair value less costs to sell of a disposal group:

  (a) to the extent that it has not been recognised in the remeasurement of scoped out non-current assets, current assets and liablities; but

  (b) not in excess of the cumulative impairment loss that has been recognised, either in accordance with this Ind AS or previously in accordance with Ind AS 36, on the non-current assets that are within the scope of the measurement requirements of this Ind AS.
- The impairment loss (or any subsequent gain) recognised for a disposal group should reduce (or increase) the carrying amount of the non-current assets in the group that are within the scope of the measurement requirements of this Ind AS, in the order of allocation set out in paragraphs 104(a) and (b) and 122 of Ind AS 36 .

  As per Para 104 (a) and (b) of Ind AS 36, Impairment of Assets, The impairment loss shall be allocated to disposal groups in the following order:

  (i) first, to reduce the carrying amount of any goodwill allocated to the disposal group; and

  (ii) then to the other assets of the disposal group pro rata on the basis of the carrying amount of each asset in the group.
- A gain or loss not previously recognised through remeasurement by the date of the sale of a noncurrent asset (or disposal group) should be recognised at the date of derecognition.

  Requirements relating to derecognition are set out in:

  (a) paragraphs 67–72 of Ind AS 16 for property, plant and equipment; and

  (b) paragraphs 112–117 of Ind AS 38, *Intangible Assets,* for intangible assets.

Example on disposal group classified as Held for Sale:

Disposal Group	Carrying amount at the reporting date before classification as held for sale ₹	Carrying amount as remeasured immediately before classification as held for sale ₹
Goodwill	1,500	1,500
Property, Plant and Equipment (carried at revalued amounts)	4,600	4,000
Building (carried at cost)	5,700	5,700
Inventory	2,400	2,200
Investment in Equity Instruments	1,800	1,500
Total	**16,000**	**14,900**

The entity should recognise the loss of ₹ 1,100 (₹ 16,000 - ₹ 14,900), in accordance with applicable Ind AS, immediately before classifying it as held for sale.

The entity estimated that fair value less costs to sell of the disposal group amounts to ₹ 13,000.

Since the entity has classified a disposal group as held for sale it should measure it at the lower of its carrying amount ₹ 14,900 and fair value less costs to sell ₹ 13,000 which comes to ₹ 13,000.

The entity should recognises an impairment loss of ₹ 1,900 (₹ 14,900 – 13,000) when the disposal group is initially classified as held for sale.

The Inventory and Investment is remeasured as per Ind AS 2 and Ind AS 109 at not more than fair value at the date of remeasurement immediately classified as held for sale.

This impairment loss of ₹ 1,900 is allocated to remaining assets in the proportion of their carrying value other than inventory and investment in equity instrument.

The allocation of impairment loss can be illustrated as follows:

Disposal Group	Carrying amount as remeasured immediately before classification as held for sale (as per applicable Ind AS) ₹	Allocated Impairment Loss ₹	Carrying amount after allocation of Impairment Loss ₹
Goodwill	1,500	(1,500)	-
Property, Plant and Equipment (carried at revalued amounts)	4,000	(165)	3,835
Building (carried at cost)	5,700	(235)	5,465
Inventory	2,200	-	2,200
Investments in equity instruments	1,500	-	1,500
Total	**14,900**	**(1,900)**	**13,000**

Firstly, the impairment loss reduces the amount of goodwill in the disposal group. Then, the remaining impairment loss is recognised to other assets pro-rata based on the carrying amount of those assets.

Suppose, at the end of reporting period the fair value less cost to sell is increased and estimated at ₹ 15,500.

The maximum impairment loss reversal allowed will be ₹ 1,900 + ₹ 1,100 being cumulative impairment loss recognised earlier.

Reversal of impairment loss is not allowed on Goodwill as it will lead to recognition of self-generated goodwill which is prohibited under Ind AS 38, Intangible Assets.

8.5.3 Changes to a plan of sale

- If an entity has classified an asset (or disposal group) as held for sale, but the held for sale criteria no longer met, the entity should cease to classify the asset (or disposal group) as held for sale.
- The entity shall measure a non-current asset that ceases to be classified as held for sale (or ceases to be included in a disposal group classified as held for sale) at the lower of:

  (a) its carrying amount before the asset (or disposal group) was classified as held for sale, adjusted for any depreciation, amortisation or revaluations that would have been recognised had the asset (or disposal group) not been classified as held for sale; and

  (b) its recoverable amount at the date of the subsequent decision not to sell.
- The entity shall include any required adjustment to the carrying amount of a non-current asset that ceases to be classified as held for sale in profit or loss from continuing operations in the period in which the held for sale criteria no longer met.
- Financial statements for the periods since classification as held for sale shall be amended accordingly if the disposal group or non-current asset that ceases to be classified as held for sale is a subsidiary, joint operation, joint venture, associate, or a portion of an interest in a joint venture or an associate.
- If an entity removes an individual asset or liability from a disposal group classified as held for sale, the remaining assets and liabilities of the disposal group will continue to be measured as a group only if the group meets the criteria for classification as held for sale. Otherwise:

  (a) the remaining non-current assets of the group that individually meet the criteria to be classified as held for sale shall be measured individually at the lower of their carrying amounts and fair values less costs to sell at that date; and

  (b) any non-current assets that do not meet the criteria shall cease to be classified as held for sale in accordance with paragraph 26.

8.6 PRESENTATION AND DISCLOSURES OF A NON-CURRENT ASSET (OR DISPOSAL GROUP) CLASSIFIED AS HELD FOR SALE

8.6.1 Non – current assets and disposal groups classified as held for sale

- Entity shall present and disclose information about non- current asset (or disposal group) classified as held for sale in such a manner that enable the user of financial statements to evaluate financial effects of non-current asset (or disposal group) classified as held for sale.

8.6.2 Presentation

- An entity is required to present a non-current asset classified as held for sale and the assets of a disposal group classified as held for sale separately from other assets in the balance sheet.
- The liabilities of a disposal group classified as held for sale should be presented separately from other liabilities in the balance sheet. Those assets and liabilities should not be offset and presented as a single amount.
- The major classes of assets and liabilities classified as held for sale should be separately disclosed either in the balance sheet or in the notes, except when the disposal group is a newly acquired subsidiary that meets the criteria to be classified as held for sale on acquisition.
- An entity should present separately any cumulative income or expense recognised in other comprehensive income relating to a non-current asset (or disposal group) classified as held for sale.
- If the disposal group is a newly acquired subsidiary that meets the criteria to be classified as held for sale on acquisition, disclosure of the major classes of assets and liabilities is not required.
- Comparative amounts for non-current assets or for the assets and liabilities of disposal groups classified as held for sale in the balance sheets for prior periods are not reclassified or re-presented to reflect the classification in the balance sheet for the latest period presented.
- Any gain or loss on the remeasurement of a non-current asset (or disposal group) classified as held for sale that does not meet the definition of a discontinued operation shall be included in profit or loss from continuing operations.

Example: Presentation of Disposal group

Property, Plant and Equipment	4,900
Inventory	1,700
Investment in equity instruments	1,400
Liabilities	(3,300)
Net Carrying Amount	**4,700**

An amount of ₹ 400 relating to these assets has been recognised in other comprehensive income and accumulated in equity.

The presentation of disposal group in entity's Balance Sheet is as follows:

Assets	**20X1-20X2**	**20X2-20X3**
Non –Current Assets		
AAA	X	X
BBB	X	X
CCC	X	X
	X	**X**
Current Assets		
DDD	X	X
EEE	X	X
	X	**X**
Non-Current Assets Classified as Held for Sale	8,000	-
	X	X
Total Assets	**X**	**X**
Equity and Liabilities		
Equity attributable to equity holders of the parent		
FFF	X	X
GGG	X	X
Amounts recognised in other comprehensive income and accumulated in equity relating to non-current assets held for sale	**400**	**-**
	X	X
Non-Controlling Interests	X	X
Total Equity	**X**	**X**
Non-Current Liabilities		
HHH	X	X

III	X	X
	X	X
Current Liabilities		
KKK	X	X
LLL	X	X
MMM	X	X
Liabilities directly associated with non-current assets classified as held for sale	3,300	-
	X	X
Total liabilities	X	X
Total Equity and liabilities	X	X

8.6.3 Disclosures

- An entity should disclose the following information in the notes to the financial statements in the period in which a non-current asset (or disposal group) has been either classified as held for sale or sold:

  (a) Description of the non-current asset (or disposal group);

  (b) Description of facts and circumstances of the sale, or leading to the expected disposal and the expected manner and timing of that disposal;

  (c) Gain or loss recognised and if not presented separately on the face of the income statement, the caption in the income statement that includes that gain or loss.

  (d) If applicable, the reportable segment in which the non-current asset (or disposal group) is presented in accordance of Ind AS 108 Operating Segments.

  (e) If there is a change of plan to sell, a description of facts and circumstances leading to the decision and its effect on results.

Illustration 2

S Ltd purchased a property for ₹ 6,00,000 on 1st April, 20X1. The useful life of the property is 15 years. On 31st March, 20X3, S Ltd classified the property as held for sale. The impairment testing provides the estimated recoverable amount of ₹ 4,70,000.

The fair value less cost to sell on 31st March, 20X3 was ₹ 4,60,000. On 31st March, 20X4 management changed the plan, as property no longer met the criteria of held for sale. The recoverable amount as at 31st March, 20X4 is ₹ 5,00,000.

Value the property at the end of 20X3 and 20X4.

Solution

(a) Value of property immediately before the classification as held for sale as per Ind AS 16 as on 31st March, 20X3

	₹	
Purchase Price	6,00,000	
Less: Accumulated Depreciation	80,000	(for two years)
Less: Impairment loss	50,000	(5,20,000-4,70,000)
Carrying Amount	**4,70,000**	

On initial classification as held for sale on 31st March, 20X3, the value will be lower of:

Carrying amount after impairment	₹ 4,70,000
Fair Value less Cost to sell	₹ 4,60,000

On 31st March, 20X3 Non-current classified as held for sale will be recorded at ₹ 4,60,000.

Depreciation of ₹ 40,000 and Impairment Loss of ₹ 60,000 (50,000 +10,000) is charged in profit or loss for the year ended 31st March, 20X3.

(b) On 31st March, 20X4 held for sale property is reclassified as criteria doesn't met. The value will be lower of:

Carrying amount immediately before classification	
on 31st March, 20X3	₹ 4,70,000
Less Depreciation based on 13 years balance life	₹ 36,154
Carrying amount had the asset is not classified as held for sale	₹ 4,33,846
Recoverable Amount	₹ 5,00,000

Property will be valued at ₹ 4,33,846 on 31st March, 20X4

Adjustment to the carrying amount of ₹ 26,154 (₹ 4,60,000 - 4,33,846) is charged to the profit or loss.

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8.7 DISCONTINUED OPERATIONS

8.7.1 Discontinued operation – definition

- Ind AS 105 defines Discontinued Operation as: A component of an entity that either has been disposed of or is classified as held for sale and:

  (a) represents a separate major line of business or geographical area of operations; or

(b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations; or

(c) is a subsidiary acquired exclusively with a view to resale.

- A *component of an entity* comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. In other words, a component of an entity will have been a cash-generating unit or a group of cash-generating units while being held for use.

Illustration 3

Sun Ltd is a retailer of takeaway food like burger and pizzas. It decides to sell one of its outlets located in chandni chowk in New Delhi. The company will continue to run 200 other outlets in New Delhi.

All Ind AS 105 criteria for held for sale classification were first met at 1st October, 20X1. The outlet will be sold in June, 20X2.

Management believes that outlet is a discontinued operation and wants to present the results of outlet as 'discontinued operations'. Analysis

Solution

The chandani chowk outlet is a disposal group; it is not a discontinued operation as it is only one outlet. It is not a major line of business or geographical area, nor a subsidiary acquired with a view to resale.

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8.7.2 Separate presentation of discontinued operations

An entity should present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations and disposals of non-current assets (or disposal groups).

This allows the user to distinguish between the operations which will continue in the future and those which will not and make it more predictable the ability of entity to generate future cash flows.

8.7.3 Presentation in the statement of profit and loss

An entity shall disclose a single amount in the statement of profit and loss comprising the total of:

(a) the post-tax profit or loss of discontinued operations; and

(b) the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.

- In addition, this single amount must be analysed into:
  - (a) the revenue, expenses and pre-tax profit or loss of discontinued operations;
  - (b) the related income tax expense as required by paragraph 81(h) of Ind AS 12;
  - (c) the gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation; and
  - (d) the related income tax expense as required by paragraph 81(h) of Ind AS 12.
- The analysis may be presented in the notes or in the statement of profit and loss. If it is presented in the statement of profit and loss it should be presented in a section identified as relating to discontinued operations, i.e. separately from continuing operations. The analysis is not required for disposal groups that are newly acquired subsidiaries that meet the criteria to be classified as held for sale on acquisition.
- Entities are required to disclose the amount of income from continuing operations and from discontinued operations attributable to owners of the parent. These disclosures may be presented either in the notes or in the statement of profit and loss.

8.7.4 Disclosures in the statement of cash flows

Disclose the net cash flows attributable to the operating, investing and financing activities of discontinued operations. These disclosures may be presented either in the notes or in the financial statements. These disclosures are not required for disposal groups that are newly acquired subsidiaries that meet the criteria to be classified as held for sale on acquisition.

When the amounts relating to discontinued operations are presented separately, the comparative figures for prior periods are also re-presented, so that the disclosures relate to all operations that have been discontinued by the end of the reporting period for the latest period presented.

8.7.5 Adjustment to prior period disposals

Adjustments in the current period to amounts previously presented in discontinued operations that are directly related to the disposal of a discontinued operation in a prior period should be classified separately in discontinued operations. The nature and amount of such adjustments are disclosed. Examples of circumstances in which these adjustments may arise include the following:

(a) the resolution of uncertainties that arise from the terms of the disposal transaction, such as the resolution of purchase price adjustments and indemnification issues with the purchaser;

(b) the resolution of uncertainties that arise from and are directly related to the operations of the component before its disposal, such as environmental and product warranty obligations retained by the seller; and

(c) the settlement of employee benefit plan obligations, provided that the settlement is directly related to the disposal transaction.

8.7.6 Change to a plan of sale

If an entity ceases to classify a component of an entity as held for sale, the results of operations of the component previously presented in discontinued operations should be reclassified and included in income from continuing operations for all periods presented. The amounts for prior periods should be described as having been re-presented.

8.7.7 Loss of Control in Subsidiary

An entity that is committed to a sale plan involving loss of control of a subsidiary should disclose the information as above when the subsidiary is a disposal group that meets the definition of a discontinued operation.

Example: Presentation of Discontinued Operations in the Statement of profit and loss.

Statement of profit and loss for the year ended 31st March, 20X3

	20X1-20X2	20X2-20X3
Continuing Operations		
Revenue	XX	XX
Cost of Sales	(XX)	(XX)
Gross Profit	XX	XX
Other Income	XX	XX
Distribution Costs	(XX)	(XX)
Administrative Expenses	(XX)	(XX)
Other Expenses	(XX)	(XX)
Finance Costs	(XX)	(XX)
Share of Profit of Associates	XX	XX
Profit before Tax	XX	XX
Income Tax Expense	(XX)	(XX)
Profit for the period from Continuing Operation	**XX**	**XX**
Discontinued Operations		
Profit for the period from discontinued Operations*	**XX**	**XX**
Profit for the period	XX	XX
Attributable to:		
Owner of the parent		
Profit for the period from continuing operations	XX	XX
Profit for the period from discontinued operations	XX	XX

Profit for the period attributable to owners of the parent	XX	XX
Non-Controlling Interests		
Profit for the period from continuing operations	XX	XX
Profit for the period from discontinued operations	XX	XX
Profit for the period attributable to non-controlling interests	XX	XX
	XX	XX

Note (a) the required analysis would be given in the notes.

8.8 SIGNIFICANT DIFFERENCES IN IND AS 105 *VIS-À-VIS* AS 24

S. No.	Particular	Ind AS 105	AS 24
	Scope and Objective	Ind AS 105 specifies the accounting for non-current assets held for sale, and the presentation and disclosure of *discontinued operations*.	AS 24 establishes principles for reporting information about *discontinuing operations*. It does not deal with the non-current assets held for sale; fixed assets retired from active used and held for sale, are dealt in existing AS 10, 'PPE'.
	Cash Flow Statement	Ind AS 105 does not mention about cash flow statement.	In the AS 24, requirements related to cash flow statement are applicable when the enterprise presents a cash flow statement.
	Discontinued vs Discontinuing Operations	Under Ind AS 105, a discontinued operation is a component of an entity that either has been disposed of or is classified as held for sale.	AS 24, there is no concept of discontinued operations but it deals with discontinuing operations.
	Time Period:	As per Ind AS 105, the sale should be expected to qualify for recognition as a completed sale within one year from the date of classification with certain exceptions.	AS 24 does not specify any time period in this regard as it relates to discontinuing operations

	Initial Disclosure Event:	Ind AS 105 does not mention so as it relates to discontinued operation.	AS 24 specifies about the initial disclosure event in respect to a discontinuing operation.
	Measurement:	Under Ind AS 105, non-current assets (disposal groups) held for sale are measured at the lower of carrying amount and fair value less costs to sell, and are presented separately in the balance sheet.	AS 24 requires to apply the principles set out in other relevant Accounting Standards, e.g., the existing AS 10 requires that the fixed assets retired from active use and held for disposal should be stated at the lower of their net book value and net realisable value and shown separately in the financial statements.
	Abandonment of Assets	Ind AS 105 specifically mentions that abandonment of assets should not be classified as held for sale.	In AS 24, abandonment of assets is classified as a discontinuing operation; however, changing the scope of an operations or the manner in which it is conducted is not abandonment and hence not a discontinuing operation.
	Guidance Regarding Measurement of Changes to a Plan of Change	Ind AS 105 provides guidance regarding changes to the plan to sell non-current assets (or disposal groups) which are classified as held for sale.	AS 24 does not give any specific guidance regarding this aspect.
	Definition:	As per Ind AS 105, a discontinued operation is a component of an entity that represents a separate major line of business or geographical area, or is a subsidiary acquired exclusively with a view to resale.	Under AS 24, a discontinuing operation is a component of an entity that represents the major line of business or geographical area of operations and that can be distinguished operationally and for financial reporting purposes.

TEST YOUR KNOWLEDGE

Questions

1. On November 30, 20X1, Entity X becomes committed to a plan to sell a property. However, it plans certain renovations to increase its value prior to selling it. The renovations are expected to be completed within a short span of time i.e., 2 months.

Can the property be classified as held for sale at the reporting date i.e. 31st December, 20X1?

2. On 1st March, 20X1, entity R decides to sell one of its factories. An agent is appointed and the factory is actively marketed. As on 31st March, 20X1, it is expected that the factory will be sold by 28th February, 20X2. However, in May 20X1, the market price of the factory deteriorated. Entity R believed that the market will recover and thus did not reduce the price of the factory. The company's accounts are authorised for issue on 26th June, 20X1. Should the factory be shown as held for sale as on 31st March, 20X1?

3. On 1st June, 20X1, entity X plans to sell a group of assets and liabilities, which is classified as a disposal group. On 31st July, 20X1, the Board of Directors approves and becomes committed to the plan to sell the manufacturing unit by entering into a firm purchase commitment with entity Y. However, since the manufacturing unit is regulated, the approval from the regulator is needed for sale. The approval from the regulator is customary and highly probable to be received by 30th November, 20X1 and the sale is expected to be completed by 31st March, 20X2. Entity X follows December year end. The assets and liabilities attributable to this manufacturing unit are as under:

(Amount in ₹)

Particulars	Carrying value as on 31st December, 20X0	Carrying value as on 31st July, 20X1
Goodwill	500	500
Plant and Machinery	1,000	900
Building	2,000	1,850
Debtors	850	1,050
Inventory	700	400
Creditors	(300)	(250)
Loans	(2,000)	(1,850)
	2,750	2,600

The fair value of the manufacturing unit as on 31st December, 20X0 is ₹ 2,000 and as on 31st July, 20X1 is ₹ 1,850. The cost to sell is 100 on both these dates. The disposal group is not sold at the period end i.e., 31st December, 20X1. The fair value as on 31st December, 20X1 is lower than the carrying value of the disposal group as on that date.

Required:

1. Assess whether the manufacturing unit can be classified as held for sale and reasons there for. If yes, then at which date?
2. The measurement of the manufacturing unit as on the date of classification as held for sale.
3. The measurement of the manufacturing unit as at the end of the year.

Answers

1. The property cannot be classified as held for sale at the balance sheet date as it is not available for sale immediately in its present condition. Although the renovations are expected to be completed within a short span 2 months, this fact is not relevant for classification.

However, if the PPE meets the criteria for held for sale by 31st January, 20X2 (i.e., 2 months from November 30, 20X1) and the accounts are not authorised by that date, then necessary disclosures need to be given in the financial statements.

2. In this example, the factory ceases to meet the definition of held for sale post the balance sheet date but before the financial statements are authorised for issue, as it is not actively marketed at a reasonable price. But, since the market conditions deteriorated post the balance sheet date, the asset will be classified as held for sale as at 31st March, 20X1.

3. ***Assessing whether the manufacturing unit can be classified as held for sale***

The manufacturing unit can be classified as held for sale due to the following reasons:

(a) The disposal group is available for immediate sale and in its present condition. The regulatory approval is customary and it is expected to be received in one year. The date at which the disposal group must be classified as held for sale is 31st July, 20X1, i.e., the date at which management becomes committed to the plan.

(b) The sale is highly probable as the appropriate level of management i.e., board of directors in this case have approved the plan.

(c) A firm purchase agreement has been entered with the buyer.

(d) The sale is expected to be complete by 31st March, 20X2, i.e., within one year from the date of classification.

Measurement of the manufacturing unit as on the date of classification as held for sale

Following steps need to be followed:

Step 1: Immediately before the initial classification of the asset (or disposal group) as held for sale, the carrying amounts of the asset (or all the assets and liabilities in the group) shall be measured in accordance with applicable Ind AS.

This has been done and the carrying value of the disposal group as on 31st July, 20X1 is determined at ₹ 2,600. The difference between the carrying value as on 31st December, 20X0 and 31st July, 20X1 is accounted for as per the relevant Ind AS.

Step 2: An entity shall measure a non-current asset (or disposal group) classified as held for sale at the lower of its carrying amount and fair value less costs to sell.

The fair value less cost to sell of the disposal group as on 31st July, 20X1 is ₹ 1,750 (i.e.1,850-100). This is lower than the carrying value of ₹ 2,600. Thus an impairment loss needs to be recognised and allocated first towards goodwill and thereafter pro-rata between assets of the disposal group which are within the scope of Ind AS 105 based on their carrying value. Thus, the assets will be measured as under:

Particulars	Carrying value – 31st July, 20X1	Impairment	Carrying value as per Ind AS 105 – 31st July, 20X1
Goodwill	500	(500)	-
Plant and Machinery	900	(115)	785
Building	1,850	(235)	1,615
Debtors	1,050	-	1,050
Inventory	400	-	400
Creditors	(250)	-	(250)
Loans	(1,850)	-	(1,850)
	2,600	(850)	1,750

Measurement of the manufacturing unit as on the date of classification as at the year end

The measurement as at the year-end shall be on similar lines as done above.

The assets and liabilities in the disposal group not within the scope of this Standard are measured as per the respective Standards.

The fair value less cost to sell of the disposal group as a whole is calculated. This fair value less cost to sell as at the year-end shall be compared with the carrying value as at the date of classification as held for sale. It is provided that the fair value as on the year end is less than the carrying amount as on that date – thus the impairment loss shall be allocated in the same way between the assets of the disposal group falling within the scope of this standard as shown above.

CHAPTER 8

INDIAN ACCOUNTING STANDARD 41: AGRICULTURE

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the objective and scope of this standard
- Describe the terms agricultural activity, agricultural produce, bearer plant, biological asset and biological transformation.
- Explain the principles of recognition and measurement.
- Compute the gain and loss on initial and subsequent measurement.
- Understand the treatment of grant relating to a biological asset.
- Describe the various disclosures prescribed in this standard.

CHAPTER OVERVIEW

Objective and Scope	Recognition and Measurement
Government Grants	Gains and losses

Agriculture
Ind AS 41

1. INTRODUCTION AND OBJECTIVE

Ind AS 41, Agriculture is the first standard that specifically covers the accounting and reporting requirements for the primary sector. Prior to this standard, there were no established guidance on agriculture and allied industry. This Standard introduces a fair value model to agriculture accounting which is a major shift away from the traditional cost model widely applied in primary industry.

Ind AS 41 Agriculture sets out the accounting for agricultural activity, the management of the transformation of biological assets (living plants and animals) into agricultural produce (harvested product of the entity's biological assets). The standard generally requires biological assets to be measured at fair value less costs to sell.

Ind AS 41 addresses following key critical issues:

(a) When should a biological asset or agricultural produce be recognised on the Balance Sheet?

(b) At what value should a recognised biological asset or agricultural produce be measured?

(c) How should the differences in value of a recognised biological asset or agricultural produce be accounted for between two different reporting dates?

(d) What should be the key disclosures?

2. SCOPE

1. This Standard shall be applied to account for the following when they **relate to agricultural activity**:

   (a) biological assets;

   (b) agricultural produce at the point of harvest; and

   (c) government grants

2. **Ind AS 41 does not apply to:**

   (a) land related to agricultural activity : for example, the land on which the biological assets grow, regenerate and/or degenerate (Ind AS 16 *Property, Plant and Equipment* and Ind AS 40 *Investment Property*);

   (b) bearer plants related to agricultural activity. Such bearer plants covered within the scope of Ind AS 16, Property, plant and Equipment as accounted as per the provisions of that standard. However, this Standard applies to the produce on those bearer plants.

   (c) government grants related to bearer plants (Ind AS 20 *Accounting for Government Grants and Disclosure of Government Assistance*).

   (d) intangible assets associated with the agricultural activity, for example licenses and rights are covered under Ind AS 38 *Intangible Assets* and provisions of this standard will be applicable.

   (e) right-of-use assets arising from a lease of land related to agricultural activity (Ind AS 116, Leases).

This Standard is applied to agricultural produce, which is the **harvested product** of the entity's biological assets, **only at the point of harvest**. Thereafter, Ind AS 2 or another applicable Standard is applied.

Example:

Processing of grapes into wine by a vintner who has grown the grapes. While such processing may be a logical and natural extension of agricultural activity, and the events taking place may bear some similarity to biological transformation, such processing is not included within the definition of agricultural activity in this Standard.

Example:

Agriculture produce after the point of harvest, for example Wool, meat, fruit, rubber, logs that are processed subsequently are not covered within purview of this standard and Ind AS 2 Inventories will apply.

The table below provides examples of biological assets, agricultural produce, and products that are the result of processing after harvest:

Biological assets	Agricultural produce	Products that are the result of processing after harvest
Sheep	Wool	Yarn, carpet
Trees in a timber plantation	Felled Trees	Logs, lumber
Dairy Cattle	Milk	Cheese
Pigs	Carcass	Sausages, cured hams
Cotton plants	Harvested cotton	Thread, clothing
Sugarcane	Harvested cane	Sugar
Tobacco plants	Picked leaves	Cured tobacco
Tea bushes	Picked leaves	Tea
Grape vines	Picked grapes	Wine
Fruit trees	Picked fruit	Processed fruit
Rubber trees	Harvested latex	Rubber products

Some plants, for example, tea bushes, grape vines, oil palms and rubber trees, usually meet the definition of a bearer plant and are within the scope of Ind AS 16, Property, plant and Equipment. However, the produce growing on bearer plants, for example, tea leaves, grapes, oil palm fruit and latex, is within the scope of Ind AS 41.

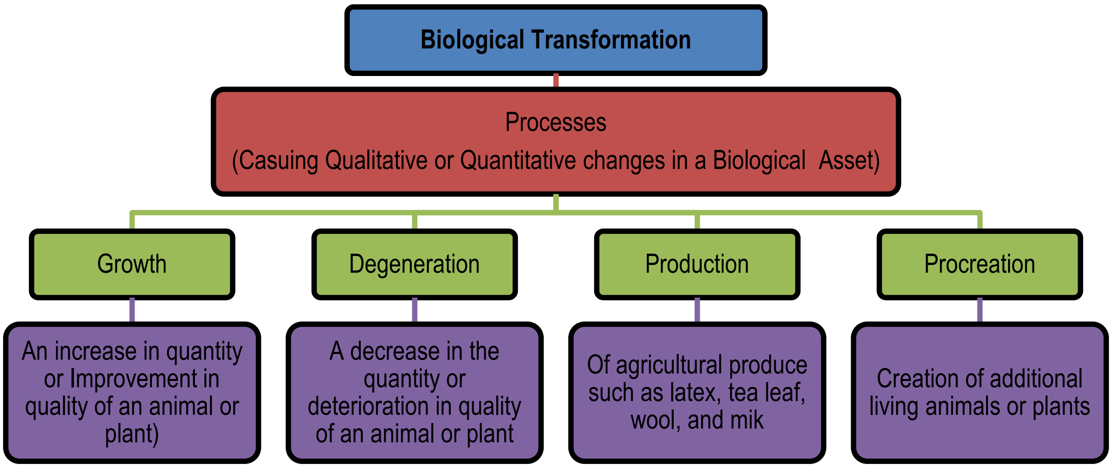
3. RELEVANT DEFINITIONS

The following are the key Agriculture-related definitions:

(a) **Agricultural activity** refers to the management by an entity of the biological transformation and harvest of biological assets for sale or for conversion into agricultural produce or into additional biological assets.

(b) **Biological Asset** is defined as a living animal or plant.

(c) **Biological transformation** comprises the processes of growth, degeneration, production, and procreation that cause qualitative or quantitative changes in biological asset.



(d) **Agricultural produce** is the harvested product of the entity's biological assets.

(e) **Harvest** is the detachment of produce from a biological asset or the cessation of a biological asset's life processes.

(f) **Fair Value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (The definition of Fair value is as given in Ind AS 113, Fair Value Measurement)

(g) **Costs to sell** are the incremental costs directly attributable to the disposal of an asset, excluding finance costs and income taxes.

(h) **Bearer plant** may be defined as a living plant that:

i. is used in the production or supply of agricultural produce;

ii. is expected to bear produce for more than one period; and

iii. has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.

For example, tea bushes, grape vines, oil palms and rubber trees, usually meet the definition of a bearer plant and are outside the scope of Ind AS 41 and covered under Ind AS 16.

However, produce growing on bearer plant is a biological asset.

Illustration 1

ABC Ltd grows vines, harvests the grapes and produces wine. Which of these activities are in the scope of Ind AS 41?

Solution

The grape vines are bearer plants that continually generate crops of grapes which are covered by Ind AS 16, Property, Plant and Equipment.

When the entity harvests the grapes, their biological transformation ceases and they become agricultural produce covered by Ind AS 41, Agriculture.

Wine involves a lengthy maturation period. This process is similar to the conversion of raw materials to a finished product rather than biological transformation hence treated as inventory in accordance with Ind AS 2, Inventories.

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4. RECOGNITION OF ASSETS

Entities are required to recognise a biological asset or agricultural produce when, and only when, all of the following conditions are met:

a) the entity controls the asset as a result of past events;

   Control over biological assets or agricultural produce may be evidenced by legal ownership or rights to control, for example legal ownership of cattle and the branding or otherwise marking of the cattle on acquisition, birth, or weaning.

b) it is probable that future economic benefits associated with the asset will flow to the entity; and

   Future economic benefits are expected to flow to the enterprise from its ownership or control of the asset. The future benefits are normally assessed by measuring the significant physical attributes.

c) the fair value or cost of the asset can be measured reliably.

5. MEASUREMENT

Biological Asset should be measured on initial recognition and at the end of each reporting period at its fair value less costs to sell, except for the case where the fair value cannot be measured reliably.

There is a presumption that fair value can be measured reliably for a biological asset. In the following cases biological asset should be measured at its cost less any accumulated depreciation and any accumulated impairment losses in accordance with Ind AS 2, Ind AS 16 and Ind AS 36:

- quoted market prices are not available for the biological assets and;
- alternative fair value measurements are determined to be clearly unreliable.

Once the fair value of such a biological asset becomes reliably measurable, an entity shall measure it at its Fair value less costs to sell.

The presumption can be rebutted only on initial recognition. An entity that has previously measured a biological asset at its fair value less costs to sell continues to measure the biological asset at its fair value less costs to sell until disposal.

In all cases, an entity measures agricultural produce at the point of harvest at its fair value less costs to sell. This Standard reflects the view that the fair value of agricultural produce at the point of harvest can always be measured reliably.

Agricultural produce harvested from an entity's biological assets should be measured at its fair value less costs to sell at the point of harvest. Such measurement is the cost at that date when applying Ind AS 2 or another applicable Standard.

The fair value measurement of a biological asset or agricultural produce may be facilitated by grouping biological assets or agricultural produce according to significant attributes; for example, by age or quality. An entity selects the attributes corresponding to the attributes used in the market as a basis for pricing.

The fair value less cost to sell of a biological asset can change due to both physical changes and price changes in the market.

Entities often enter into contacts to sell their biological assets or agricultural produce at a future date. Contract prices are not necessarily relevant in measuring fair value, because fair value reflects the current market conditions in which market participant buyers and sellers would enter into a transaction. As a result, the fair value of a biological asset or agricultural produce is not adjusted because of the existence of a contract.

Cost may sometimes approximate fair value, particularly when:

a) little biological transformation has taken place since initial cost incurrence (for example, for fruit tree seedlings planted immediately prior to the end of a reporting period or newly acquired livestock); or

b) the impact of the biological transformation on price is not expected to be material (for example, for the initial growth in a 30-year pine plantation production cycle)

Biological assets are often physically attached to land (for example, trees in a plantation forest). There may be no separate market for biological assets that are attached to the land but an active market may exist for the combined assets, that is, the biological assets, raw land, and land improvements, as a package. An entity may use information regarding the combined assets to measure the fair value of the biological assets. For example, the fair value of raw land and land improvements may be deducted from the fair value of the combined assets to arrive at the fair value of biological assets.

Illustration 2

A farmer owned a dairy herd, of three years old cattle as at 1st April, 20X1 with a fair value of ₹ 13,750 and the number of cattle in the herd was 250.

The fair value of three year cattle as at 31st March, 20X2 was ₹ 60 per cattle. The fair value of four year cattle as at 31st March, 20X2 is ₹ 75 per cattle.

Calculate the measurement of group of cattle as at 31st March, 20X2 stating price and physical change separately.

Solution

Particulars	Amount (₹)
Fair value as at 1st April, 20X1	13,750
Increase due to Price change [250 x {60 - (13,750/250)}]	1,250
Increase due to Physical change [250 x {75-60}]	3,750
Fair value as at 31st March, 20X2	18,750

*****

Illustration 3

XYZ Ltd., on 1st December, 20X3, purchased 100 sheep from a market for ₹ 5,00,000. The transaction cost of 2% on the market price of the sheep was incurred which was paid by the seller. Sheep's fair value increased from ₹ 500,000 to ₹ 600,000 on 31st March, 20X4. Transaction cost of 2% would have to be incurred by the seller to get the sheep to the relevant market.

Determine the fair value on the date of purchase and the reporting date and pass necessary journal entries thereon.

Solution

The fair value less cost to sell of sheep's on the date of purchase would be ₹ 4,90,000 (5,00,000-10,000). Expense of ₹ 10,000 would be recognised in profit and loss.

<u>On date of Purchase</u>

Biological Asset	Dr.	4,90,000	
Loss on initial recognition	Dr.	10,000	
To Bank			5,00,000

(Being biological asset purchased)

On 31st March, 20X4 sheep would be measured at ₹ 5,88,000 as Biological Asset (6,00,000-12,000) and gain of ₹ 98,000 (5,88,000 - 4,90,000) would be recognised in profit or loss.

<u>At the end of reporting period</u>

Biological Asset	Dr.	98,000	
To Gain – Change in fair value			98,000

(Being change in fair value recognised at the end of reporting period)

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6. GAINS AND LOSSES

1) Biological Asset:

A gain or loss arising on initial recognition of a Biological Asset at Fair value less costs to sell and from a change in Fair value less costs to sell of a biological asset shall be included in Profit or Loss for the period in which it arises.

A loss may arise on initial recognition of a biological asset, because cost to sell are deducted in determining fair value less cost to sell of a biological asset. A gain may arise on initial recognition of a biological asset, such as when a calf is born.

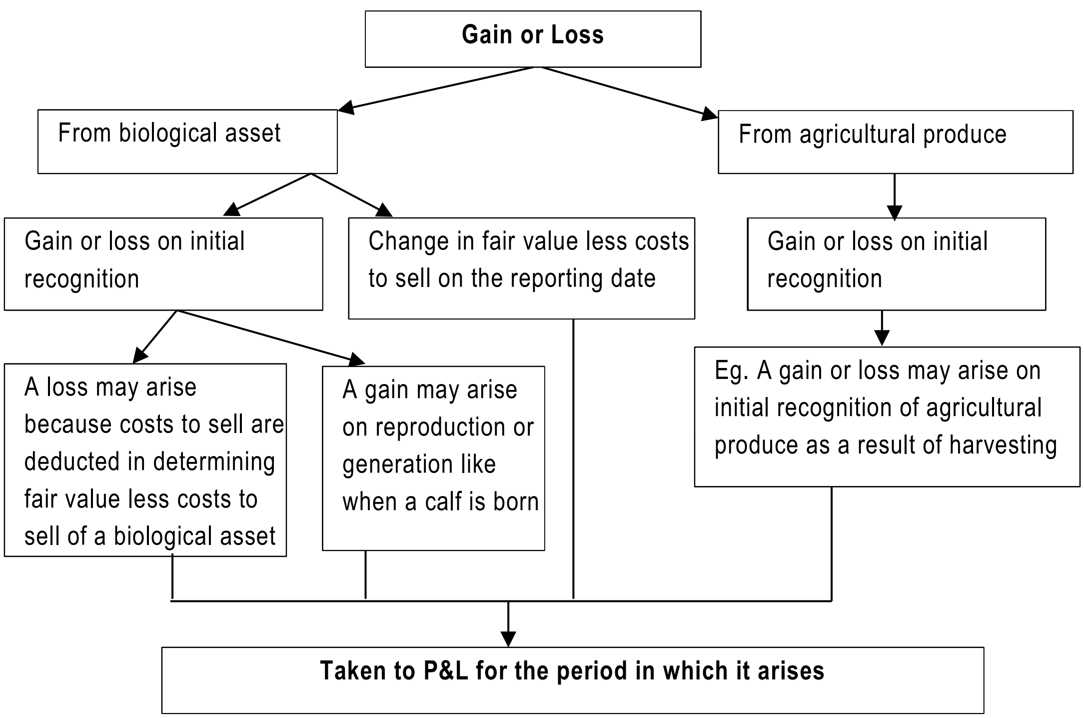
Example:

During the reporting period 20X1-20X2, an entity is having a cow which has given birth to a calf. The fair value less estimated cost to sell for a calf is ₹ 5,000. The amount of ₹ 5,000 is, therefore, immediately recognised in Statement of Profit or Loss.

2) Agriculture Produce:

A gain or loss arising on initial recognition of agricultural produce at fair value less costs to sell shall be included in profit or loss for the period in which it arises.

A gain or loss may arise on initial recognition of agricultural produce as a result of harvesting.



7. GOVERNMENT GRANTS

1) Biological Asset measured at fair value less cost to sell:-

a) Unconditional Grant:

An unconditional government grant related to a biological asset measured at its fair value less costs to sell shall be recognised in profit or loss when, and only when, the government grant becomes receivable.

b) Conditional Grant:

If a government grant related to a biological asset measured at its fair value less costs to sell is conditional, including when a government grant requires an entity not to engage in specified agricultural activity, an entity shall recognise the government grant in profit or loss when, and only when, the conditions attaching to the government grant are met.

Terms and conditions of government grants vary. For example, a grant may require an entity to farm in a particular location for five years and require the entity to return the entire grant if it farms for a period shorter than five years. In this case, the grant is not recognised in profit or loss until the five years have passed. However, if the terms of the grant allow part of it to be retained according to the time elapsed, the entity recognises that part in profit or loss as time passes.

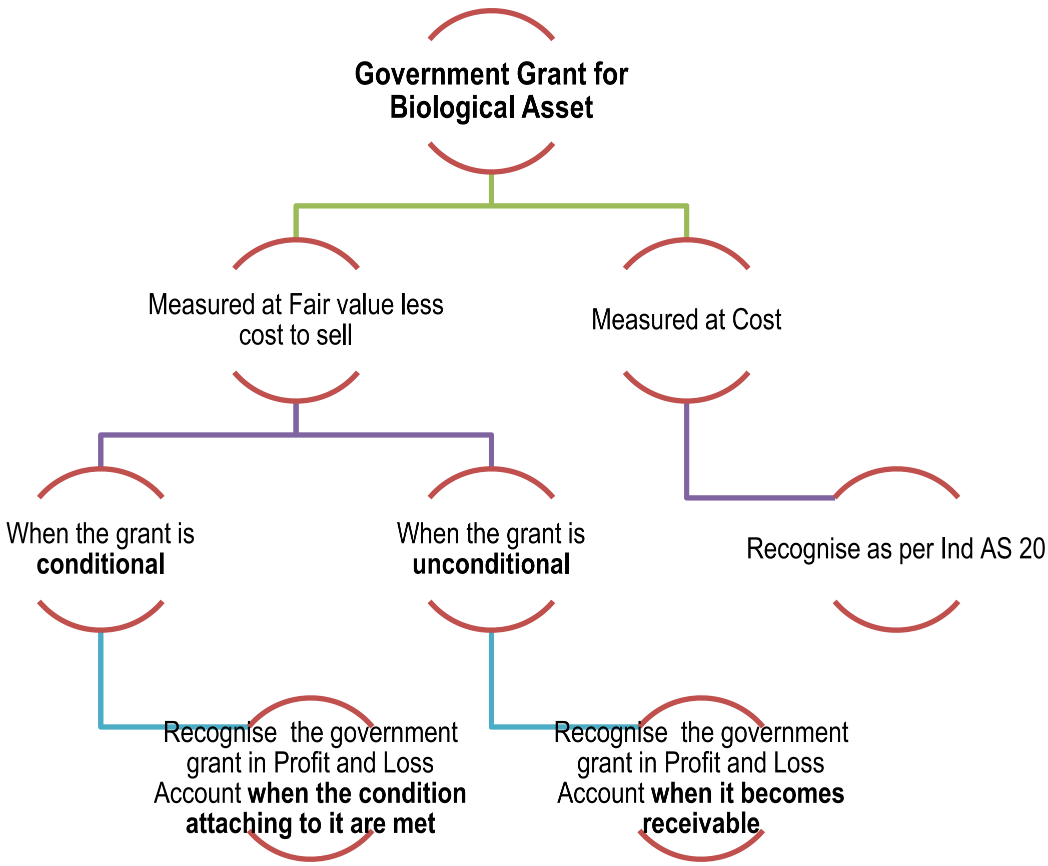
Example:

Sun Ltd cultivated a huge plot of land. The government offers a grant of ₹ 10 crore under the condition that the land is being cultivated for 5 years. If the land will be cultivated for a shorter period, the entity is required to return the entire grant.

Therefore, the government grant will be recognised as income only after 5 years of cultivation. The situation would be different if the returning obligation referred to the years of not cultivating the land is with respect to retention of grant for the period till which the entity has cultivated the land. In this case, the amount of ₹ 10 crore would be recognised as income, proportionately with the time period, meaning ₹ 2 crore per annum.

2) Biological Asset measured at its cost:

If a government grant relates to a Biological Asset measured at its cost less any accumulated depreciation and any accumulated impairment losses i.e. (i.e. inability to measure fair value reliably), Ind AS 20 is applied.



8. DISCLOSURE

1) Description of biological assets and activities.

The entity is required to a description of each group of biological assets. This disclosure may take the form of a narrative or quantified description. An entity is encouraged to provide a quantified description of each group of biological assets, distinguishing between consumable and bearer biological assets or between mature and immature biological assets, as appropriate.

2) Gains and losses recognised during the period.

An entity shall disclose the aggregate gain or loss arising during the current period on initial recognition of biological assets and agricultural produce and from the change in fair value less costs to sell of biological assets.

3) Reconciliation of changes in biological assets.

A detailed reconciliation is required of changes in the carrying amount of biological assets between the beginning and the end of the current period, which includes:

a) gain or loss arising from changes in fair value less costs to sell;

b) increases arising from purchases;

c) decreases attributable to sales and biological assets classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with Ind AS 105;

d) decreases due to harvest;

e) increases resulting from business combinations;

f) net exchange differences arising on the translation of financial statements into a different presentation currency, and on the translation of a foreign operation into the presentation currency of the reporting entity; and

g) other changes.

4) Restricted assets, commitments and risk management strategies.

The entity should disclose:

a) the existence and carrying amounts of biological assets whose title is restricted, and the carrying amounts of biological assets pledged as security for liabilities;

b) the amount of commitments for the development or acquisition of biological assets; and

c) financial risk management strategies related to agricultural activity.

5) Additional disclosures when fair value cannot be measured reliably.

If biological assets within the scope of Ind AS 41 are measured at cost less any accumulated depreciation and any accumulated impairment losses at the end of the period, the following disclosures are required:

a) a description of the biological assets;

b) an explanation of why fair value cannot be measured reliably;

c) the range of estimates within which fair value is highly likely to lie;

d) the depreciation method used;

e) the useful lives or the depreciation rates used; and

f) the gross carrying amount and the accumulated depreciation and impairment losses at the beginning and end of the period.

6) Government grants

The following disclosures are required for government grants relating to agricultural activity:

a) the nature and extent of government grants recognised;

b) unfulfilled conditions and other contingencies attaching to government grants; and

c) significant decreases expected in the level of government grants.

Illustration 4

Moon Ltd prepares financial statements to 31st March, each year. On 1st April 20X1 the company carried out the following transactions:

-- *Purchased a land for ₹ 50 Lakhs.*

-- *Purchased 200 dairy cows (average age at 1st April, 20X1 two years) for ₹ 10 Lakhs.*

-- *Received a grant of ₹ 1 million towards the acquisition of the cows. This grant was non-refundable.*

For the year ending 31st March, 20X2, the company has incurred following costs:

-- *₹ 6 Lakh to maintain the condition of the animals (food and protection).*

-- *₹ 4 Lakh as breeding fee to a local farmer.*

On 1st October, 20X1, 100 calves were born. There were no other changes in the number of animals during the year ended 31st March, 20X2. As of 31st March, 20X2, Moon Ltd had 3,000 litres of unsold milk in inventory. The milk was sold shortly after the year end at market prices.

Information regarding fair values is as follows:

Item	Fair Value less cost to sell		
	1st April, 20X1	1st October, 20X1	31st March, 20X2
	₹	₹	₹
Land	50 Lakhs	60 Lakhs	70 Lakhs
New born calves (per calf)	1,000	1,100	1,200
Six month old calves (per calf)	1,100	1,200	1,300
Two year old cows (per cow)	5,000	5,100	5,200
Three year old cows (per cow)	5,200	5,300	5,500
Milk (per litre)	20	22	24

Prepare extracts from the Balance Sheet and Statement of Profit & Loss that would be reflected in the financial statements of the entity for the year ended 31st March, 20X2.

Solution

Extract from the Statement of Profit & Loss

	WN	Amount
Income		
Change in fair value of purchased dairy cow	WN 2	1,00,000
Government Grant	WN 3	10,00,000
Change in the fair value of newly born calves	WN 4	1,30,000
Fair Value of Milk	WN 5	72,000
Total Income		**13,02,000**
Expenses		
Maintenance Costs	WN 2	6,00,000
Breeding Fees	WN 2	4,00,000
Total Expense		**(10,00,000)**
Net Income		**3,02,000**

Extracts from Balance Sheet

Property, Plant and Equipment:		
Land	WN 1	50,00,000
Biological assets other than bearer plants:		
Dairy Cow	WN 2	11,00,000
Calves	WN 4	1,30,000
		62,30,000
Inventory:		
Milk	WN 5	72,000
		72,000

Working Notes:

1. Land: The purchase of the land is not covered by Ind AS 41. The relevant standard which would apply to this transaction is Ind AS 16. Under this standard the land would initially be recorded at cost and depreciated over its useful economic life. This would usually be considered to be infinite in the case of land and so no depreciation would be appropriate. Under Cost Model no recognition would be made for post-acquisition changes in the value of land. The allowed alternative treatment under Revaluation Model would permit the land to be revalued to market value with the revaluation surplus taken to the other comprehensive

income. We have followed the Cost Model.

2. **Dairy Cows:** Under the 'fair value model' laid down in Ind AS 41 the mature cows would be recognised in the Balance Sheet at 31st March, 20X2 at the fair value of 200 x ₹ 5,500 = ₹11,00,000.

   Increase in price change 200 x (5,200-5,000) = 40,000

   Increase in physical change 200 x (5,500-5,200) = 60,000

   The total difference between the fair value of matured herd and its initial cost (₹ 11,00,000 – ₹ 10,00,000 = a gain of ₹ 1,00,000) would be recognised in the profit and loss along with the maintenance costs and breeding fee of ₹ 6,00,000 and ₹ 4,00,000 respectively.

3. **Grant:** Grand relating to agricultural activity is not subject to the normal requirement of Ind AS 20. Under Ind AS 41 such grants are credited to income as soon as they are unconditionally receivable rather than being recognised over the useful economic life of the herd. Therefore, ₹ 10,00,000 would be credited to income of the company.

4. **Calves:** They are a biological asset and the fair value model is applied. The breeding fees are charged to income and an asset of 100 x ₹ 1,300 = ₹ 1,30,000 recognised in the Balance sheet and credited to Profit and loss.

5. **Milk:** This is agricultural produce and initially recognised on the same basis as biological assets. Thus the milk would be valued at 3,000 x ₹ 24 = ₹ 72,000. This is regarded as 'cost' for the future application of Ind AS 2 to the unsold milk.

*****

TEST YOUR KNOWLEDGE

Question

As at 31st March, 20X1, a plantation consists of 100 Pinus Radiata trees that were planted 10 years earlier. The tree takes 30 years to mature, and will ultimately be processed into building material for houses or furniture. The enterprise's weighted average cost of capital is 6% p.a.

Only mature trees have established fair values by reference to a quoted price in an active market. The fair value (inclusive of current transport costs to get 100 logs to market) for a mature tree of the same grade as in the plantation is:

As at 31st March, 20X1: 171

As at 31st March, 20X2: 165

Assume that there would be immaterial cash flow between now and point of harvest.

The present value factor of ₹ 1 @ 6% for

19th year = 0.331

20th year = 0.312

State the value of such plantation as on 31st March, 20X1 and 20X2 and the gain or loss to be recognised as per Ind AS.

Answer

As at 31st March, 20X1, the mature plantation would have been valued at 17,100 (171 x 100).

As at 31st March, 20X2, the mature plantation would have been valued at 16,500 (165 x 100).

Assuming immaterial cash flow between now and the point of harvest, the fair value (and therefore the amount reported as an asset on the statement of financial position) of the plantation is estimated as follows:

As at 31st March, 20X1: 17,100 x 0.312 = 5,335.20.

As at 31st March, 20X2: 16,500 x 0.331 = 5,461.50.

Gain or loss

The difference in fair value of the plantation between the two year end dates is 126.30 (5,461.50 – 5,335.20), which will be reported as a gain in the statement or profit or loss (regardless of the fact that it has not yet been realised).

Final Course

(Revised Scheme of Education and Training)

Study Material

(Modules 1 to 4)

PAPER 1

Financial Reporting

MODULE – 3

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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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SIGNIFICANT CHANGES

Significant changes in this Module 3 *vis-à-vis* Module 4 of November, 2018 edition of the Study Material *(The amendments made in the respective chapters / units have been highlighted in bold and italics for easy reference except newly added illustrations)*		
Chapter No.	**Title of the chapter**	**Details**
9 unit 1	Ind AS 19	• The whole unit has been improvised • Para 1.8.1.1 Step IV, para 1.9.3.3, para 1.11 and para 1.11.1 have been amended • Illustration 4, 10, 11, Example (at page 9.30) and Test Your Knowledge Questions 1,6 and 7 have been newly added
10 unit 1	Ind AS 12	• Second example given at para 1.6.3 point (f) has been amended • Para 1.6.6 point (g) has been newly added
10 unit 2	Ind AS 21	• The whole unit has been improvised • Illustration 3, 4, 8 and Test Your Knowledge Question 2 have been newly added
11 unit 2	Ind AS 33	Certain pictorial charts have been added in the unit for quick understanding of the concept
11 unit 3	Ind AS 108	Certain pictorial charts have been revised / added in the unit for quick understanding of the concept
12	Financial Instruments	In Unit 1 • Para 1.3 bullet on 'physical assets, right-of-use assets and intangible assets' has been amended • Para 1.6 'Scope of Financial instruments' has been amended

		In Unit 3 • Para 3.3 (B) Contractual cash flows characteristics test - Example (b) of SPPI has been amended In Unit 5 • Para 6.5 ‘Other disclosures’ has been amended

CONTENTS

DETAILED CONTENTS: MODULE – 3

CHAPTER 9- IND AS ON LIABILITIES OF THE FINANCIAL STATEMENTS

Unit 1: Indian Accounting Standard 19: Employee Benefits

Contents:

Unit 2: Indian Accounting Standard 37: Provisions, Contingent Liabilities and Contingent Assets

Contents:

CHAPTER 10- IND AS ON ITEMS IMPACTING THE FINANCIAL STATEMENTS

Unit 1: Indian Accounting Standard 12: Income Taxes

Contents:

Unit 2: Indian Accounting Standard 21: The Effects of changes in Foreign Exchange Rates

Contents:

CHAPTER 11-IND AS ON DISCLOSURES IN THE FINANCIAL STATEMENTS

Unit 1: Indian Accounting Standard 24: Related Party Disclosures

Contents:

Unit 2: Indian Accounting Standard 33: Earnings Per Share

Contents:

Unit 3: Indian Accounting Standard 108: Operating Segments

Contents:

CHAPTER 12 – ACCOUNTING AND REPORTING OF FINANCIAL INSTRUMENTS

Contents:

Unit 1 – Financial Instruments: Scope and Definitions

Unit 2 – Financial Instruments: Equity and Financial Liabilities

CHAPTER 9

IND AS ON LIABILITIES OF THE FINANCIAL STATEMENTS

UNIT 1: INDIAN ACCOUNTING STANDARD 19: EMPLOYEE BENEFITS

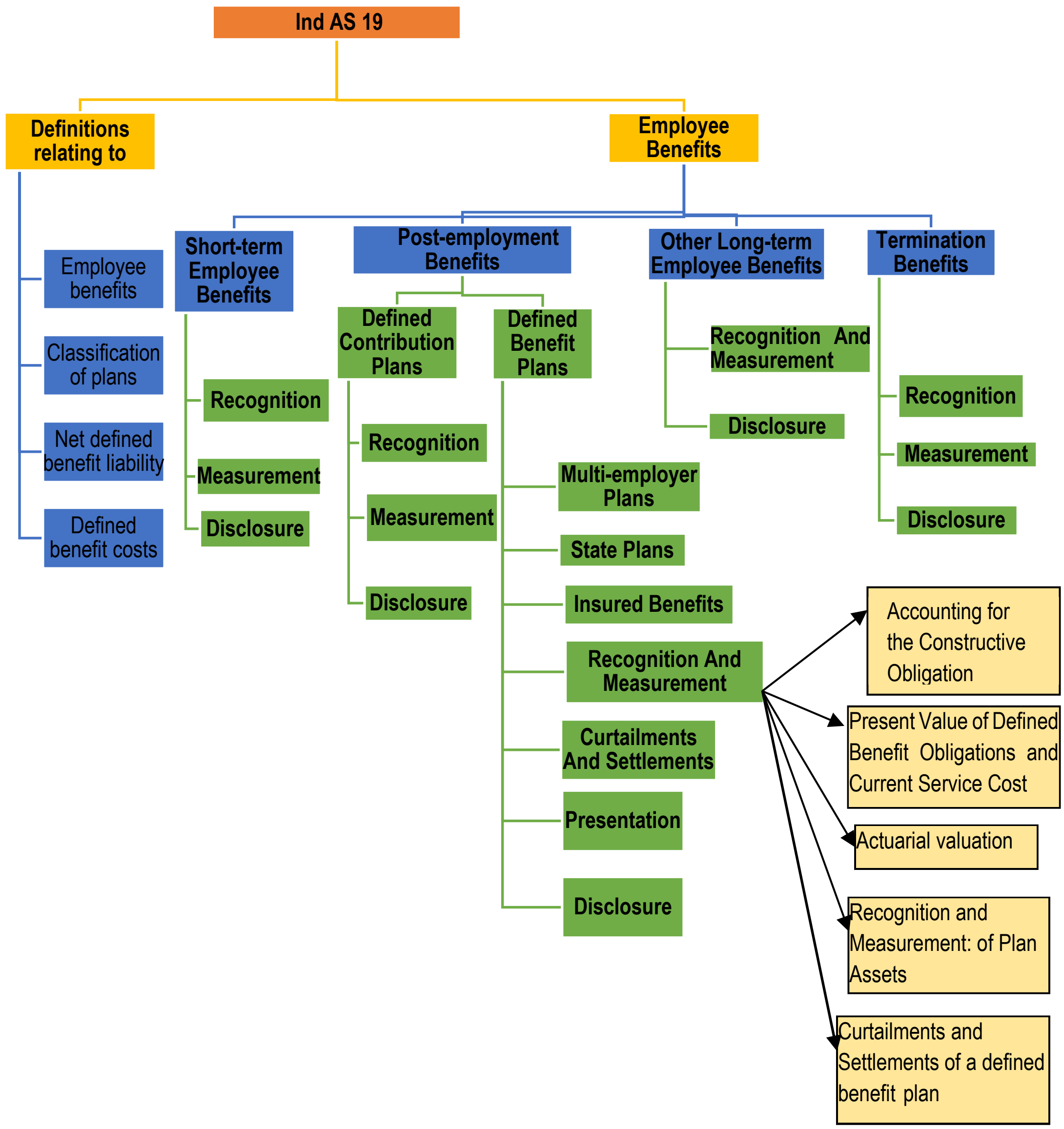
LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand the objective and scope of Ind AS 19
- Define the terms relating to employee benefits, classification of plans, net defined benefit liability (asset) and defined benefit cost
- Examine the four categories of employee benefits (short-term, post-employment, other long- term and termination benefits)
- Recognise and measure all short term employee benefits, short term paid absences and account for profit sharing and bonus plans
- Make distinction between defined contribution plans and defined benefit plans
- Account for multiemployer plans, state plans and insured benefits
- Recognise and measure defined benefit plans that share risks between entities under common control
- Recognise, measure and disclose defined contribution plans

- Account for the constructive obligation plans under defined benefit plan
- Apply actuarial valuations in recognition and measurement of defined benefit plans
- Remeasure the net defined benefit liability (asset) using the current fair value of plan assets and current actuarial assumptions
- Determining past service cost, or a gain or loss on settlement,
- Recognise the components of defined benefit cost
- Present and disclose employee benefits in the financial statements as per Ind AS 19

UNIT OVERVIEW



1.1 OBJECTIVE OF IND AS 19

- The objective of this standard is to prescribe the accounting and disclosure for employee benefits.
- Ind AS 19 requires an entity to recognise:
  - (a) a liability for advance services received from an employee; and
  - (b) an expense for consumption of economic benefits raised from the service provided by an employee in exchange for employee benefits.

1.2 SCOPE

- This Standard shall be applied by an employer in **accounting for all employee benefits** other than benefits to which Ind AS 102, *Share-based Payment*, is applicable.
- This Standard does not deal with reporting by employee benefit plans.
- Employee benefits to which this Standard applies include those provided
  - under formal plans/agreements between an entity and its individual employees/group of employees/their representatives,
  - as required by law or as required by any type of industry arrangements whereby an entity is required to contribute to any nation/state/industry or other multi-employer plans; or
  - by those informal practices that give rise to a constructive obligation. Informal practices give rise to a constructive obligation where the entity has no realistic alternative but to pay employee benefits.

    Example of a constructive obligation - Where a change in the entity's informal practices would cause unacceptable damage to its relationship with employees.

1.3 EMPLOYEE BENEFITS

Employee benefits include:

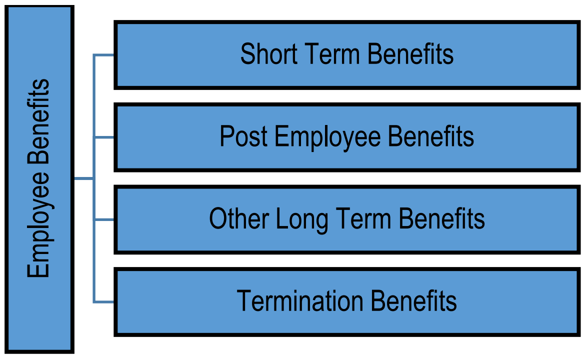
(i) short employee benefits,

(ii) post-employment benefits,

(iii) other long term employee benefits and

(iv) termination benefits.

All these categories have different characteristics and hence the Standard has specified separate accounting requirements for each such category.



- Employee benefits include benefits provided either to
  - employees; or
  - their dependants; or
  - their beneficiaries.
- Employee benefits may be settled by payments (or the provision of goods or services) made either
  - directly to the employees; or
  - their spouses; or
  - their children; or
  - their other dependants; or
  - others, such as insurance companies.
- An employee may provide services to an entity on a
  - full-time; or
  - part-time; or
  - permanent; or
  - casual; or
  - temporary

  basis.

Note: For the purpose of this Standard, employees include directors and other management personnel.

1.4 DEFINITIONS

1.4.1 Definitions of employee benefits

1. ***Employee Benefits:*** All forms of consideration given by an entity in exchange for service rendered by employees or for the termination of employment.

2. ***Short-term Employee Benefits:*** Employee benefits (other than termination benefits) that are expected to be settled wholly **before twelve months** after the end of the annual reporting period in which the employees render the related service.

   Example : Wages, salaries, paid annual leave.

3. ***Post-employment Benefits:*** Employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment.

   Example : Pensions, lumpsum payments on retirement.

4. ***Other long-term employee benefits*** are all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits.

   Example : Long-term paid absences such as long-service leave or sabbatical leave, jubilee or other long-service benefits.

5. ***Termination benefits*** are employee benefits provided in exchange for the termination of an employee's employment as a result of either:

   (a) an entity's decision to terminate an employee's employment before the normal retirement date; or

   (b) an employee's decision to accept an offer of benefits in exchange for the termination of employment.

1.4.2 Definitions relating to classification of plans

1. ***Post-employment Benefit Plans:*** These plans are formal or informal arrangements under which an entity provides post-employment benefits for one or more employees.

   Under these plans, the benefits are given to the employees after employment, like gratuity, pension, provident fund etc.

   Note: Defined contribution plans and defined benefit plans are two categories of post-employment benefits plans.

2. ***Defined Contribution Plans:*** They are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have **no** legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all

employee benefits relating to employee service in the current and prior periods.

In these plans, the contribution is defined i.e. contribution is fixed and known to the entity.

Example : Provident Fund contribution by the employer to the Employees' Provident Fund Organisation, Ministry of Labour & Employment, Government of India.

3. ***Defined Benefit Plans:*** Post-employment benefit plans other than defined contribution plans.

Example: Gratuity.

4. ***Multi-employer Plans:*** Defined contribution plans (other than state plans) or defined benefit plans (other than state plans) that:

   (a) pool the assets contributed by various entities that are not under common control; and

   (b) use those assets to provide benefits to employees of more than one entity, on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employs the employees.

1.4.3 Definitions relating to the net defined benefit liability (asset)

1. ***Net defined benefit liability (asset)***: The deficit or surplus, adjusted for any effect of limiting a net defined benefit asset to the asset ceiling.

2. ***Deficit or surplus:***

   (a) the present value of the defined benefit obligation ***less***

   (b) the fair value of plan assets (if any).

3. ***Asset ceiling**:* The present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

4. ***Present Value of a Defined Benefit Obligation:*** Present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.

5. ***Plan assets*** comprise:

   (a) assets held by a long-term employee benefit fund; and

   (b) qualifying insurance policies.

6. ***Assets held by a long-term employee benefit fund:*** Assets (other than non-transferable financial instruments issued by the reporting entity) that:

   (a) are held by an entity (a fund) that is legally separate from the reporting entity and exists solely to pay or fund employee benefits; and

   (b) are available to be used only to pay or fund employee benefits, are not available to the reporting entity's own creditors (even in bankruptcy), and cannot be returned to the reporting entity, unless either:

(i) the remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting entity; or

(ii) the assets are returned to the reporting entity to reimburse it for employee benefits already paid.

6. ***Qualifying Insurance Policy:*** Insurance policy issued by an insurer that is not a related party (as defined in Ind AS 24, *Related Party Disclosures*) of the reporting entity, if the proceeds of the policy:

(a) can be used only to pay or fund employee benefits under a defined benefit plan; and

(b) are not available to the reporting entity's own creditors (even in bankruptcy) and cannot be paid to the reporting entity, unless either:

(i) the proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations; or

(ii) the proceeds are returned to the reporting entity to reimburse it for employee benefits already paid.

7. ***Fair Value:*** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (Ind AS 113, Fair Value Measurement.)

1.4.4 Definitions relating to defined benefit cost

1. ***Service cost*** comprises:

(a) *Current service cost*, which is the increase in the present value of the defined benefit obligation resulting from employee service in the current period;

(b) *Past service cost,* which is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or a curtailment (a significant reduction by the entity in the number of employees covered by a plan); and

(c) any gain or loss on settlement.

2. ***Net interest on the net defined benefit liability (asset):*** The change during the period in the net defined benefit liability (asset) that arises from the passage of time.

3. ***Remeasurements of the net defined benefit liability (asset)*** comprise:

(a) actuarial gains and losses;

(b) the return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset); and

(c) any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset).

4. ***Actuarial gains and losses*** are changes in the present value of the defined benefit obligation resulting from:

(a) experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred); and

(b) the effects of changes in actuarial assumptions.

5. ***Return on plan assets:*** Interest, dividends and other income derived from the plan assets, together with realised and unrealised gains or losses on the plan assets, less:

(a) any costs of managing plan assets; and

(b) any tax payable by the plan itself, other than tax included in the actuarial assumptions used to measure the present value of the defined benefit obligation.

6. ***Settlement:*** A transaction that eliminates all further legal or constructive obligations for part or all of the benefits provided under a defined benefit plan, other than a payment of benefits to, or on behalf of, employees that is set out in the terms of the plan and included in the actuarial assumptions.

1.5 SHORT-TERM EMPLOYEE BENEFITS

❖ Short-term employee benefits include items expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related services.

❖ It includes

(a) wages, salaries and social security contributions;

(b) paid annual leave and paid sick leave;

(c) profit-sharing and bonuses; and

(d) non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees.

❖ Reclassification of a short-term employee benefit is not required if the entity's expectations of the timing of settlement of such benefits changes temporarily.

❖ Reclassification may be considered-

o if the characteristics of the benefit change (such as a change from a non-accumulating benefit to an accumulating benefit) or

o if a change in expectations of the timing of settlement is not temporary.

1.5.1 Recognition and Measurement of Short-term Benefits

Accounting for short term benefits has two characteristics:

(a) short term benefits are measured on an undiscounted basis; and

(b) they don't involve any actuarial valuation for their measurement.

The undiscounted amount of short-term employee benefits expected to be paid in exchange for that service shall be recognised:

(a) as a liability (accrued expense), after deducting any amount already paid.

If the amount already paid exceeds the undiscounted amount of the benefits, an entity shall recognise that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund; and

(b) as an expense, if it doesn't form part of the cost of an asset as per any other Ind AS 2 or Ind AS 16.

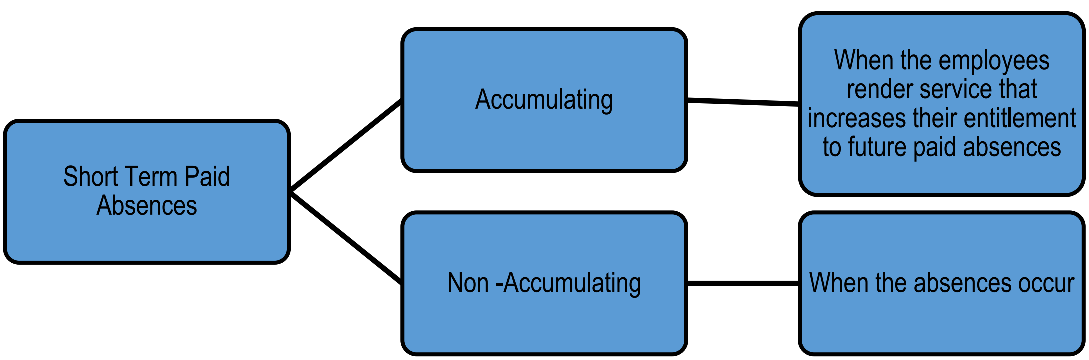
Note: Recognition of short term employee benefit is in the form of either paid expenses or profit sharing or bonus plans.

1.5.2 Short -term paid absences

An employer may compensate an employee for absence for various reasons including holidays, sickness and short-term disability, maternity or paternity, jury service and military service. Entitlement to paid absences (i.e. compensated balances) fall into two categories and are recognized as follows:

(a) **Accumulating** paid absences - recognized when the employees render service that increases their entitlement to future paid absences; and

(b) **Non-accumulating** paid absences - recognized when the absences occur.



1.5.2.1 Accumulating Paid Absences

- These are the absences that are carried forward and can be used in future periods if the employee is not able to use them in current reporting period of the employer. They can be either:
  - (i) **Vesting:** In this case, employees are entitled to a cash-payment for the unutilised entitlement at the time of leaving the entity; and
  - (ii) **Non-vesting:** In this case, employees are not entitled to a cash payment for unused entitlement on leaving.
- This obligation exists and is recognized, even if the compensated absences are non-vesting. However, in case an employee leaves the entity before they use an accumulated non-vesting entitlement, it will affect the measurement of this obligation.
- An entity shall measure the expected cost of accumulating compensated absences as the **additional amount that the entity expects to pay as a result of the unused entitlement** that has accumulated at the end of the reporting period.

Illustration 1

Sunderam Pvt. Ltd. has a headcount of 100 employees in 20X0-20X1. As per the employee policy, the employees are entitled to:

- *30 casual leaves out of which 10 casual leaves may be carried forward to the next year; and*
- *10 sick leaves out of which 2 sick leaves may be carried forward as paid leave.*

At March 31, 20X1, the average unused entitlement is 5 days per employee for casual leaves and 1 day per employee for sick leave. On an average, it is found that the number of such employees who would be claiming casual leaves would be 30 and 10 employees who would claim sick leaves.

Compute the liability to be recognised in respect of sick leaves and casual leaves by the entity at the end of the financial year 20X0-20X1.

Solution

The entity will recognise liability in the books equal to 150 (30 x 5) days of paid casual leaves and 10 (10 x 1) days of sick pay.

*****

1.5.2.2 Non-accumulating Paid Absences:

- These are the absences that do not carry forward and they will lapse if the current period's entitlement is not used in full by the employee.
- They do not entitle employees to a cash payment for unused entitlement on leaving the entity.

Example: Sick pay (to the extent that unused past entitlement does not increase future entitlement).

- An entity shall recognise no liability or expense until the time of the absence because the employee service does not increase the amount of the benefit.

1.5.3 Profit-sharing and Bonus Plans

- Expected costs of profit-sharing and bonus plans shall be recognised when and only when:
  - (a) the entity has a present legal or constructive obligation to make such payments as a result of past events; and
  - (b) a reliable estimate of the obligation can be made by the entity.
- A present obligation exists when, and only when, an entity has no realistic alternative but to make the payments in lieu of profits and bonuses to its employees.
- Under some profit-sharing plans, employees receive a share of the profit only if they remain with the entity for a specified period. Such plans create a constructive obligation as employees render service that increases the amount to be paid if they remain in service until the end of the specified period. The measurement of such constructive obligations reflects the possibility that some employees may leave without receiving profit-sharing payments.
- An entity may have no legal obligation to pay a bonus. Nevertheless, in some cases, an entity has a practice of paying bonuses. In such cases, the entity has a constructive obligation because the entity has no realistic alternative but to pay the bonus. The measurement of the constructive obligation reflects the possibility that some employees may leave without receiving a bonus.
- An entity can make a reliable estimate of its legal or constructive obligation under a profit- sharing or bonus plan when, and only when:
  - (a) the formal terms of the plan contain a formula for determining the amount of the benefit;
  - (b) the entity determines the amounts to be paid before the financial statements are approved for issue; or
  - (c) past practice gives clear evidence of the amount of the entity's constructive obligation.
- An obligation under profit-sharing and bonus plans results from employee service and not from a transaction with the entity's owners.
- Therefore, **an entity recognises the cost of profit-sharing and bonus plans not as a distribution of profit but as an expense**.

Illustration 2

Laxmi Mills is a profit making entity and has reported ₹ 200 crore in the financial year 20X1-20X2. According to its profit–sharing plan, it distributes and pays 5% as its portion of profit to its employees if they complete 1 year with the organisation.

Under this plan, an entity is under an obligation to pay if the employees complete a specified period with the organisation. Laxmi Mills has estimated that due to staff turnover in the organisation, the estimated pay-out would be around 4.5%.

Compute the liability and expense of the company under this plan.

Solution

The company shall recognize a liability and an expense of an amount of ₹ 9 crores for the financial year 20X1-20X2 (i.e. 4.5% of ₹ 200 crores).

*****

❖ If profit-sharing and bonus payments are **not settled wholly before the twelve months after the end of the reporting period** in which the employees render the related service, those payments are **considered as other long –term employee benefits**.

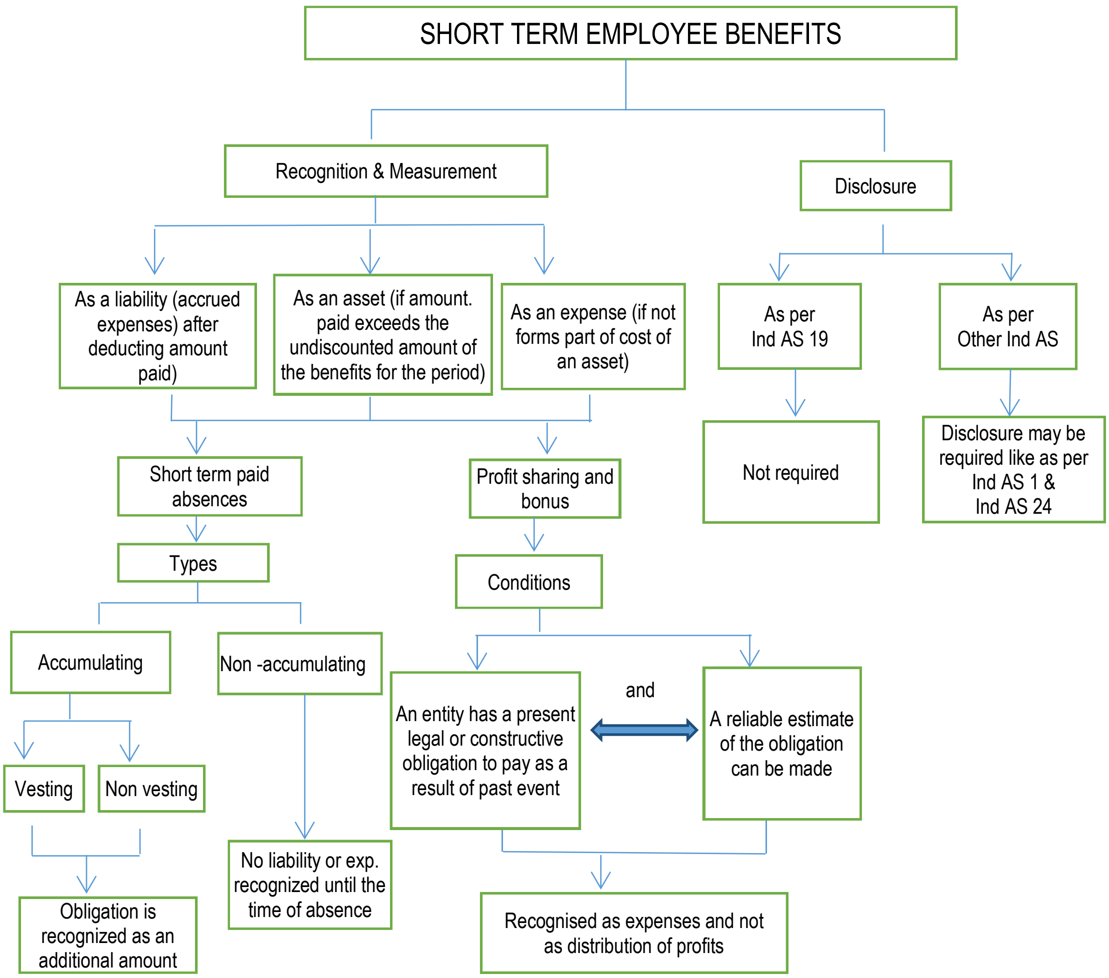
1.5.4 Disclosure

❖ This Standard does not require specific disclosures about short-term employee benefits.

❖ However, other Ind AS may require disclosures.

Examples:

- Ind AS 24 requires disclosures about employee benefits for key management personnel.
- Ind AS 1, Presentation of Financial Statements, requires disclosure of employee benefits expense.



1.6 POST-EMPLOYMENT BENEFITS

❖ Post-employment benefits include:

(a) Retirement benefits such as pensions and lump sum payments on retirement; and

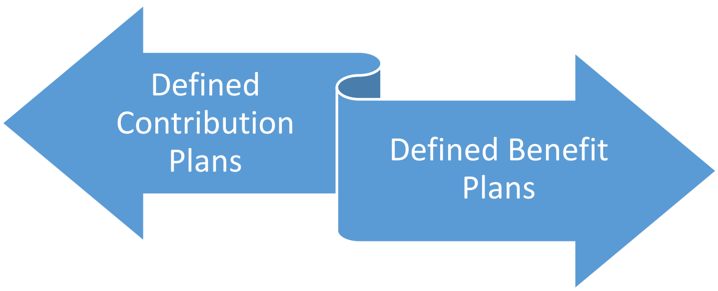
(b) Other post-employment benefit such as post-employment life insurance and post-employment medical care.

❖ Depending upon the economic substance of the plan which is derived from its principal terms and conditions, post-employment benefit plans are classified as

(i) **either** defined contribution plans

(ii) **or** defined benefit plans.

1.6.1 Classification of Post-employment Benefit Plans into Defined Contribution Plan vs Defined Benefit Plans



1.6.1.1 Under defined contribution plans

(a) The entity's legal or constructive obligation is limited to the amount that it agrees to contribute to the fund.

(b) Thus, the amount of the post-employment benefits received by the employee is determined by the amount of contributions paid by an entity (and perhaps also the employee) to a post-employment benefit plan or to an insurance company, together with investment returns arising from the contributions.

(c) As a result of this, actuarial risk (which means that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall, in substance on the employee (and not on the entity like in defined benefit plan).

Exception:

There are cases where an entity's obligation is not limited to the amount that it agrees to contribute to the fund as the entity has a legal or constructive obligation. Examples of such cases are listed below:

(a) a plan benefit formula that is not linked solely to the amount of contributions and requires the entity to provide further contributions if assets are insufficient to meet the benefits in the plan benefit formula;

(b) a guarantee, either indirectly through a plan or directly, of a specified return on contributions; or

(c) informal practices that give rise to a constructive obligation.

For example, a constructive obligation may arise where an entity has a history of increasing benefits for former employees to keep pace with inflation even where there is no legal obligation to do so.

1.6.1.2 Under defined benefit plans

(a) The entity's obligation is to provide the agreed benefits to current and former employees; and

(b) Actuarial risk (that benefits will cost more than expected) and investment risk fall, in substance, on the entity (and not on the employee like in the case of defined contribution plan).

(c) Thus, if actuarial or investment experience are worse than expected, the entity's obligation may be increased.

The above differences can be summarized as follows:

S. No.	Particulars	Defined Contribution Plans	Defined Benefit Plans
1.	*Entity's obligation*	The entity's legal or constructive obligation **is limited to the amount** that it agrees to contribute to the fund.	The entity's obligation is to **provide the agreed benefits** to current and former employees.
2.	*Risk bearer*	Actuarial risk and investment risk **fall on the employee** and not on the entity.	Actuarial risk and investment risk **fall on the entity** and not on the employee.
3.	*Change in the obligation*	Generally, no change in the contribution of an entity is made except in certain cases.	If actuarial or investment experience are worse than expected, **the entity's obligation may be increased** for providing to the employees.
4.	*Determination of the amount of post-employment benefit*	The amount of the post-employment benefits received by the employee is determined by the amount of contributions paid by an entity and employee as well.	Pre-determined / Agreed post-employment benefits are received by the employee.

1.6.2 Multi-employer Plans

- An entity shall classify a multi-employer plan as a defined contribution plan or a defined benefit plan under the terms of the plan (including any constructive obligation that goes beyond the formal terms).
- In the case of a multi-employer defined benefit plan, normally
  - The amount of contributions is decided keeping in mind the amount of benefits that an entity is required to pay in the same period and
  - The future benefits that an entity gets during the current period will be paid out of future contributions.
  - Employers have no realistic means of withdrawing from the plan without paying a contribution for the benefits earned.
  - Employees' benefits are determined by the length of their service in the entity as a future amount which is required to be paid to them. Such a plan would create actuarial risk to the entity (i.e. if the ultimate cost of benefits already earned at the end of the reporting period is more than expected, the entity will have to either increase its contributions or to persuade employees to accept a reduction in benefits).
- In case the multi-employer plan is a defined benefit plan, an entity shall:

  (a) account for its proportionate share of the

  (i) defined benefit obligation,

  (ii) plan assets and

  (iii) cost associated with the plan

  in the same way as for any other defined benefit plan; and

  (b) disclose the information required.
- When sufficient information is not available to use defined benefit accounting for a multi-employer plan that is a defined benefit plan, an entity shall:

  (a) account for the plan as if it were a defined contribution plan;

  (b) disclose:

  (i) the fact that the plan is a defined benefit plan;

  (ii) the reason why sufficient information is not available to enable the entity to account for the plan as a defined benefit plan; and

  (iii) the expected contributions to the plan for the next annual reporting period; and

(c) to the extent that a surplus or deficit in the plan may affect the amount of future contributions, disclose in addition:

   (i) any available information about that surplus or deficit;

   (ii) the basis used to determine that surplus or deficit; and

   (iii) the implications, if any, for the entity.

❖ The reasons that an entity is not able to term its plan as a defined benefit plan and has to account for a plan as multi-employer defined contribution plan include:

   ➢ an entity is not having access to sufficient information about the plan to satisfy the requirements of this Standard; or

   ➢ the plan exposes the entity to actuarial risks associated with the current and former employees of other entities, with the result that there is no consistent and reliable basis for allocating the obligation, plan assets and cost to individual entities participating in the plan.

❖ There may be a contractual agreement between the multi-employer plan and its participants that determines how the surplus in the plan will be distributed to the participants (or the deficit funded). A participant in a multi-employer plan with such an agreement that accounts for the plan as a defined contribution plan shall recognise

   ➢ the asset or liability that arises from the contractual agreement and

   ➢ the resulting income or expense in profit or loss.

❖ In determining when to recognise, and how to measure, a liability relating to the wind-up of a multi-employer defined benefit plan, or the entity's withdrawal from a multi-employer defined benefit plan, an entity shall apply Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

Illustration 3

Paras Pvt. Ltd. does not have sufficient information about a defined benefit plan and thus accounts for the plan as if it were defined contribution plan.

In the plan, there is a contractual agreement between Paras Pvt. Ltd. and its participants to share the deficit amongst all. The funding valuation shows a deficit of ₹ 500 million in the plan. The plan has agreed under contract a schedule of contributions with the participating employers in the plan that will eliminate the deficit over the next 10 years. The entity's total contributions under the contract are ₹ 30 million.

Solution

As per Ind AS 19, Paras Pvt. Ltd. should recognise a liability for the contributions adjusted for the time value of money and an equal expense in profit or loss.

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1.6.3 Defined Benefit Plans that Share Risks between Entities under Common Control

- Defined benefit plans that share risks between entities under common control, for example, a parent and its subsidiaries, are not multi-employer plans.
- An entity who is participating in such a plan shall obtain information about the plan as a whole on the basis of assumptions that apply to whole plan as a whole.
- The entity shall, in its separate or individual financial statements, recognise the net defined benefit cost it charged, if there is a contractual agreement or stated policy for charging the net defined benefit cost for the whole plan to individual group entities.
- In case there is no such agreement or policy, the net defined benefit cost shall be recognised in the separate or individual financial statements of the group entity that is legally the sponsoring employer for the plan.
- The other group entities shall, in their separate or individual financial statements, recognise a cost equal to their contribution payable for the period.
- This kind of participation in such a plan is a related party transaction for each individual group entity. Therefore, following **disclosures** are required by an entity in its separate or individual financial statements:

  (a) the contractual agreement or stated policy according to which net defined benefit cost has been charged by the individual entity or the fact that there is no such policy.

  (b) the policy for determining the contribution to be paid by the entity.

  (c) if the entity accounts for an allocation of the net defined benefit cost, then disclosure has to be made for information about the whole plan.

  (d) if the entity accounts for the contribution payable for the period, the information about the plan also needs to be disclosed for the plan as a whole.

1.6.4 State Plans

- A state plan is accounted for in the same way as a multi-employer plan.
- State plans are normally established by legislation to cover all entities (or all entities in a particular category, for example, a specific industry) and are operated by national or local government or by another body (for example, an autonomous agency created specifically for this purpose) which is not subject to control or influence by the reporting entity.
- Some plans established by an entity provide both compulsory benefits, as a substitute for benefits that would otherwise be covered under a state plan, and additional voluntary benefits. Such plans are not state plans.

- State plans are characterised as defined benefit or defined contribution, depending on the entity's obligation under the plan.
- Many state plans are funded on a pay-as-you- go basis which implies that contributions are set at a level that is expected to be sufficient to pay the required benefits falling due in the same period. In such kind of a case, future benefits earned during the current period will be paid out of future contributions.
- In most of the state plans, the entity has no legal or constructive obligation to pay those future benefits as its only obligation as an entity is to pay the contributions as they fall due and in case the entity does not employ members of the state plan, it will have no obligation to pay the benefits earned by its own employees in previous years. For this reason, state plans are normally defined contribution plans.

1.6.5 Insured Benefits

- An entity normally pays insurance premiums for funding a post-employment benefit plan. The entity shall treat such a plan as a defined contribution plan.
- The entity shall treat the plan as a defined benefit plan in case an entity has (either directly, or indirectly through the plan) a legal or constructive obligation, either to pay:
  (a) the employee benefits directly when they fall due; or
  (b) further amounts if the insurer does not pay all future employee benefits which are relating to employee service in the current and prior periods.
- Where an entity is funding a post-employment benefit obligation and contributes to an insurance policy under which the entity retains a legal or constructive obligation, in this case the payment of the premiums does not amount to a defined contribution arrangement. This can be either directly or indirectly through the plan, through the mechanism for setting future premiums or through a related party relationship with the insurer. Hence the entity shall:
  (a) account for a qualifying insurance policy as a plan asset; and
  (b) recognise other insurance policies as reimbursement rights.
- The entity has no obligation to pay benefits to the employees and the insurer has sole responsibility for paying the benefits where an insurance policy is in the name of a specified plan participant or a group of plan participants and the entity does not have any legal or constructive obligation to cover any loss on the policy.
- The payment of fixed premiums under such kind of arrangement is a settlement of the employee benefit obligation rather than an investment to meet the obligation. Therefore, an entity treats such payments as contributions to a defined contribution plan.

1.7 ACCOUNTING FOR DEFINED CONTRIBUTION PLANS

- The reporting entity's obligation for each period is determined by the amounts to be contributed for that period.
- No actuarial assumptions are required to measure the obligation or the expense and there is no possibility of any actuarial gain or loss.
- The obligations are measured on an undiscounted basis.

Exception:

Discounting is done where the obligation falls due after twelve months after the end of the annual reporting period in which the employees render the related service.

1.7.1 Recognition and Measurement

When an employee has rendered service to an entity during a period, the entity shall **recognise the contribution payable** to a defined contribution plan in exchange for that service:

(a) as a liability (accrued expense), after deducting any contribution already paid.

In case the amount of contribution already paid under a defined contribution plan exceeds the contribution due for service before the end of the reporting period, an entity shall recognise that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, a reduction in future payments or a cash refund; and

(b) as an expense if not included in the cost of an asset as per other Ind AS (for example, according to Ind AS 2 and Ind AS 16).

Where contributions to a defined contribution plan do not fall due wholly before twelve months after the end of the annual reporting period in which the employees render the related service, the contributions shall be discounted using the discount rate as specified in this Standard.

1.7.2 Disclosure

- An entity shall disclose the amount recognised as an expense for defined contribution plans.
- An entity shall disclose information about contributions to defined contribution plans for key management personnel (as per Ind AS 24).

1.8 ACCOUNTING FOR DEFINED BENEFIT PLANS

Accounting for defined benefit plans is complex because -

- actuarial assumptions are required to measure the obligation and the expense;

- there is a possibility of actuarial gains and losses;
- the obligations are measured on a discounted basis because they may be settled many years after the employees render the related service.

1.8.1 Recognition and Measurement

- Defined benefit plans can be:
  - unfunded or
  - funded.

    They may be funded wholly or partly by contributions by an entity, and sometimes its employees, into an entity, or fund, that is legally separate from the reporting entity and from which the employee benefits are paid.
- The payment of funded benefits when they fall due depends on
  - the financial position and the investment performance of the fund; and
  - an entity's ability (and willingness) to make good any shortfall in the fund's assets.
- Therefore, the entity, in substance, underwrites the actuarial and investment risks associated with the plan.
- Hence the expense recognised for a defined benefit plan is not necessarily the amount of the contribution due for the period.

1.8.1.1 Steps involved in Accounting by an entity for defined benefit plans

Determine the deficit or surplus	• PUCM (Projected Unit Credit Method) • Discounting • Fair value of plan assets
Determine the amount of the net defined benefit liability (asset)	• As the amount of the deficit or surplus
Determine the amounts to be recognised in Profit or Loss	• Current service cost • Past service cost • Net interest
Determine the remeasurements of the net defined benefit liability (asset)	• Acturial Gain or Loss • Return on Plan Assets • Any Change in effect of Asset Ceiling

Step I: Determining the Deficit or Surplus

This involves:

(a) using actuarial techniques, the projected unit credit method, to make a reliable estimate of the amount of benefit that employees have earned in return for their service in the current and prior periods.

This requires an entity to -

(i) determine how much benefit is attributable to the current and prior periods and

(ii) make estimates (actuarial assumptions) about

- demographic variables (such as employee turnover and mortality); and
- financial variables (such as future increases in salaries and medical costs)

that will influence the cost of the benefit;

(b) discounting that benefit in order to determine the present value of the defined benefit obligation; and the current service cost

(c) deducting the fair value of any plan assets from the present value of the defined benefit obligation.

Step II: Determining the amount of the net defined benefit liability (asset)

Determining the amount of the net defined benefit liability (asset) as the amount of the deficit or surplus determined in step I above, adjusted for any effect of limiting a net defined benefit asset to the asset ceiling.

Step III: Determining amounts to be recognised in profit or loss:

(i) current service cost.

(ii) any past service cost and gain or loss on settlement.

(iii) net interest on the net defined benefit liability (asset).

Step IV: Determining the remeasurements of the net defined benefit liability (asset), to be recognised in other comprehensive income, comprising:

(i) actuarial gains and losses;

(ii) return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset); and

(iii) any change in the effect of the asset ceiling, **excluding** amounts included in net interest on the net defined benefit liability (asset).

In case an entity has more than one defined benefit plan, the entity applies these procedures for each material plan separately.

An entity shall determine the net defined benefit liability (asset) with sufficient regularity that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the end of the reporting period.

1.8.2 Accounting for the Constructive Obligation

- Accounting for any constructive obligation will also be done by an entity that arises from the entity's informal practices.
- Constructive obligation arises due to informal practices where the entity has no realistic alternative but to pay employee benefits.

  Example - Where a change in the entity's informal practices would cause unacceptable damage to its relationship with employees.
- The formal terms of a defined benefit plan may permit an entity to terminate its obligation under the plan. Nevertheless, it is usually difficult for an entity to terminate its obligation under a plan (without payment) if employees are to be retained.
- Hence accounting for post-employment benefits assumes that an entity which is currently promising such benefits will continue to do so over the remaining working lives of employees, in the absence of evidence to the contrary.

1.8.3 Balance Sheet

- An entity shall recognise the net defined benefit liability (asset) in the balance sheet.
- When an entity has a surplus in a defined benefit plan, it shall measure the net defined benefit asset **at the lower of:**

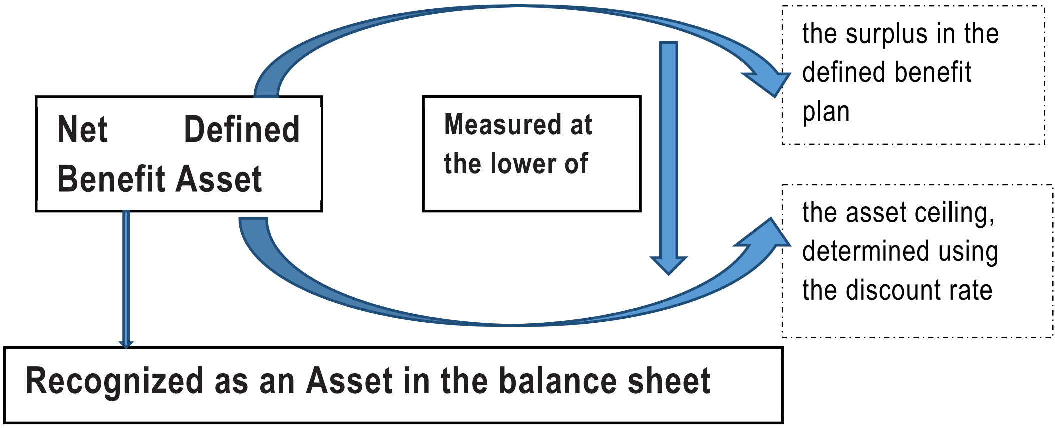
  (a) the surplus in the defined benefit plan; and

  (b) the asset ceiling, determined using the discount rate.
- A net defined benefit asset may arise where a defined benefit plan has been overfunded or in certain cases where actuarial gains are arisen. An entity recognises a net defined benefit asset in such cases because:

  (a) the entity controls a resource, which is the ability to use the surplus to generate future benefits;

  (b) that control is a result of past events (contributions paid by the entity and service rendered by the employee); and

  (c) future economic benefits are available to the entity in the form of a reduction in future contributions or a cash refund, either directly to the entity or indirectly to another plan in deficit.



1.9 RECOGNITION AND MEASUREMENT: PRESENT VALUE OF DEFINED BENEFIT OBLIGATIONS AND CURRENT SERVICE COST

The cost of a defined benefit plan is influenced by many variables, such as

- final salaries;
- employee turnover and mortality;
- employee contributions; and
- medical cost trends.

Hence the ultimate cost of the plan is uncertain and this uncertainty is likely to persist over a long period of time.

In order to measure the present value of the post-employment benefit obligations and the related current service cost, it is necessary to:

(a) apply an actuarial valuation method;

(b) attribute benefit to periods of service; and

(c) make actuarial assumptions.

1.9.1 Actuarial Valuation Method

❖ Projected Unit Credit Method (PUCM) is used by an entity to determine the present value of its defined benefit obligations and the related current service cost and, where applicable, past service cost.

❖ The Projected Unit Credit Method (which is also sometimes known as the accrued benefit method pro-rated on service or as the benefit/years of service method) perceives each period of service as which gives rise to an additional unit of benefit entitlement and measures each unit separately to build up the final obligation.

Illustration 4

AJ Ltd is engaged in the business of trading of chemicals having a net worth of ₹ 150 crores. The company's profitability is good and hence the company has introduced various benefits for its employees to keep them motivated and to ensure that they stay with the organization. The company is an associate of RJ Ltd which is listed on Bombay Stock Exchange in India.

The company initially did not have any HR function but over the last 2 years, the management set up that function and now HR department takes care of all the benefits related to the employees and how they can be structured in a manner beneficial to both the employees and the objectives of the company.

One of the employee benefits involves a lump sum payment to employee on termination of service and that is equal to 1 per cent of final salary for each year of service. Consider the salary in year 1 is ₹ 10,000 and is assumed to increase at 7 per cent (compound) each year.

Taking a discount rate at 10 per cent per year, you are required to show

(a) benefits attributed (year on year) and

(b) the obligation in respect of this benefit (year on year)

For and employee who is expected to leave at the end of year 5

Following assumptions may be taken to solve this:

- There are no changes in actuarial assumptions.
- No additional adjustments are needed to reflect the probability that the employee may leave the entity at an earlier or later date.

Solution

a. Computation of benefit attributed to prior years and current year:

Amount in ₹

Year	**1**	**2**	**3**	**4**	**5**
Benefit attributed to:					
- Prior years	-	131	262	393	524
- Current year (Refer W.N.1)	131	131	131	131	131
Total (i.e. current and prior years)	**131**	**262**	**393**	**524**	**655**

b. **Computation of the obligation for an employee who is expected to leave at the end of year 5 (taking discount rate of 10% p.a.)** Amount in ₹

Year	**1**	**2**	**3**	**4**	**5**
Opening obligation (A)	-	89	196	324	475
Interest at 10% B = (A X 10%)	-	9	20	32	47
Current service cost (C) (Refer WN 2)	89	98	108	119	131
Closing obligation D = (A+B+C)	**89**	**196**	**324**	**475**	**653**

Figures have been rounded off in the above table.

Working Notes

1. A lump sum benefit is payable on termination of service and equal to 1 per cent of final salary for each year of service. The salary in year 1 is ₹ 10,000 and is assumed to increase at 7 per cent (compound) each year.

The year on year salary would be as follows: ₹

Year	**1**	**2**	**3**	**4**	**5**
Salary	10,000	10,700 (10,000 x 107%)	11,449 (10,700 x 107%)	12,250 (11,449 x 107%)	13,108 (12,250 x 107%)

Accordingly, for the purpose of above mentioned employee benefit, 1% of final salary to be considered for each year of service would be ₹ 131.

2. Computation of current service cost: ₹

Year	**1**	**2**	**3**	**4**	**5**
1% salary at the end of year 5	-	-	-	-	131
PV factor at the end of each year to be considered at 10% p.a. **(E)**	0.683	0.751	0.826	0.909	1.000
PV at the end of each year	89 (131 x E)	98 (131 x E)	108 (131 x E)	119 (131 x E)	131 (131 x E)

Accordingly, for the purpose of above mentioned employee benefit, 1% of final salary to be considered for each year of service would be ₹ 131.

*****

❖ An entity discounts the whole of a post-employment benefit obligation, even if part of the obligation is expected to be settled before twelve months after the reporting period.

1.9.2 Attributing Benefit to Periods of Service

- An entity shall attribute benefit to periods of service under the plan's benefit formula, in determining the present value of its defined benefit obligations and the related current service cost, and, where applicable, past service cost.
- However, if an employee's service in later years will lead to a materially higher level of benefit than in earlier years, an entity shall attribute benefit on a straight-line basis from:

  (a) the date when service by the employee first leads to benefits under the plan (whether or not the benefits are conditional on further service) until

  (b) the date when further service by the employee will lead to no material amount of further benefits under the plan, other than from further salary increases.
- The Projected Unit Credit Method requires an entity to attribute benefit to the current period (in order to determine current service cost) and the current and prior periods (in order to determine the present value of defined benefit obligations).

  An entity will attribute benefit to periods in which the obligation to provide post-employment benefits arises as employees render services in return for post-employment benefits which an entity expects to pay in future reporting periods.
- These kind of actuarial techniques allow an entity to measure that obligation with sufficient reliability to justify recognition of a liability.

Illustration 5

A defined benefit plan provides a lump-sum benefit of ₹ 200 payable on retirement for each year of service. A benefit of ₹ 200 is attributed to each year. The current service cost is the present value of ₹ 200. The present value of the defined benefit obligation is the present value of ₹ 200, multiplied by the number of years of service up to the end of the reporting period. What is the current service cost?

Solution

If the benefit is payable immediately when the employee leaves the entity, the current service cost and the present value of the defined benefit obligation reflect the date at which the employee is expected to leave. Thus, because of the effect of discounting, they are less than the amounts that would be determined if the employee left at the end of the reporting period.

*****

- Employee service gives rise to an obligation under a defined benefit plan even if the benefits are conditional on future employment (***in other words they are not vested***).

- Employee service given the vesting date gives rise to a constructive obligation because, at the end of each successive reporting period, the amount of future service that an employee will have to render before becoming entitled to the benefit is reduced. An entity considers the probability that some employees may not satisfy any vesting requirements in measuring its defined benefit obligation.
- Although, certain post-employment benefits, for example, post- employment medical benefits, become payable only if a specified event occurs when an employee is no longer employed, an obligation is created when the employee renders service that will provide entitlement to the benefit if the specified event occurs.

  The probability that the specified event will occur affects the measurement of the obligation, but does not determine whether the obligation exists.

Illustration 6

A plan pays a benefit of ₹ 150 for each year of service. The benefits vest after ten years of service. Compute the benefit to be attributed each year?

Solution

A benefit of ₹ 150 is attributed to each year. In each of the first ten years, the current service cost and the present value of the obligation reflect the probability that the employee may not complete ten years of service.

*****

Illustration 7

A plan pays a benefit of ₹ 150 for each year of service, excluding service before the age of 25. The benefits vest immediately. Compute the benefit to be attributed each year?

Solution

No benefit is attributed to the service before the age of 25 because service before that date does not lead to benefits (conditional or unconditional). A benefit of ₹ 150 is attributed to each subsequent year.

*****

- The obligation increases till the date when further service by the employee will lead to no material amount of further benefits. Therefore, all benefit is attributed to periods ending on or before that date. Benefit is attributed to individual accounting periods under the plan's benefit formula.

  However, in case an employee renders service in later years which will lead to a materially higher level of benefit than in earlier years, an entity will attribute benefit on a straight-line basis until the date when further service by the employee will lead to no material amount of further benefits. That is because the employee's service throughout the entire period will ultimately lead to benefit at that higher level.

Example illustrating above paragraph

A plan pays a lump-sum retirement benefit of ₹ 4,000 to all employees who are still employed at the age of 55 after twenty years of service, or who are still employed at the age of 65, regardless of their length of service.

For employees who join before the age of 35, service first leads to benefits under the plan at the age of 35 (an employee could leave at the age of 30 and return at the age of 33, with no effect on the amount or timing of benefits). Those benefits are conditional on further service. Also, service beyond the age of 55 will lead to no material amount of further benefits. For these employees, the entity attributes benefit of ₹ 200 (₹ 4,000 divided by 20) to each year from the age of 35 to the age of 55.

For employees who join between the ages of 35 and 45, service beyond twenty years will lead to no material amount of further benefits. For these employees, the entity attributes benefit of ₹ 200 (₹ 4,000 divided by 20) to each of the first twenty years.

For an employee who joins at the age of 55, service beyond ten years will lead to no material amount of further benefits. For this employee, the entity attributes benefit of ₹ 400 (₹ 4,000 divided by 10) to each of the first ten years.

For all employees, the current service cost and the present value of the obligation reflect the probability that the employee may not complete the necessary period of service.

Illustration 8

Amra Pvt. Ltd. has a plan for its employees where it has decided to pay a lump-sum benefit of ₹ 2,000 that will vest after ten years of service. However, that plan will provide no further benefit for subsequent service.

Compute the benefit attributed for 10 years of service and for the period of service after 10 years?

Solution

In this case, as per the company's plan, a benefit of ₹ 200 (₹ 2,000 divided by 10) is attributed to each of the first 10 years. The current service cost in each of the first ten years reflects the probability that the employee may not complete ten years of service.

No benefit is attributed to subsequent years.

*****

Illustration 9

Sanat Pvt. Ltd. has a plan for the employees where employees are entitled to a benefit of 5 % of final salary for each year of service before the age of 55. Compute the benefit attributed up to 55 years and after 55?

Solution

Benefit of 5% of estimated final salary is attributed to each year up to the age of 55. This is the date when further service by the employee will lead to no material amount of further benefits under the plan. No benefit is attributed to service after that age.

*****

Illustration 10

AKJ Ltd is a listed company engaged in the business of manufacturing of electronic equipment. The company has various branch offices spread out across India and has 1,000 employees.

As per the statutory requirements, gratuity shall be payable to an employee on the termination of his employment after he has rendered continuous service for not less than five years -

(a) on his superannuation, or

(b) on his retirement or resignation, or

(c) on his death or disablement due to accident or disease.

The completion of continuous service of five years shall not be necessary where the termination of the employment of any employee is due to death or disablement.

The amount payable is determined by a formula linked to number of years of service and last drawn salary. The amount payable to an employee shall not exceed ₹ 10,00,000.

Compute the amount of employee benefit, if any, attributed to each year of service.

Solution

The amount of gratuity would be attributed to each year of service and calculated as follows:

Number of employees not likely to fulfill the eligibility criteria will be ignored.

Other employees will be grouped according to period of service they are expected to render taking into account:

- mortality rate,
- disablement and
- resignation after 5 years.

Gratuity payable will be calculated in accordance with the formula prescribed in the governing statute based on the period of service and the salary at the time of termination of employment, assuming promotion, salary increases etc.

For those employees for whom the amount payable as per the formula does not exceed ₹ 10,00,000, over the expected period of service, the amount payable will be divided by the expected period of service and the resulting amount will be attributed to each year of the expected period of service, including the period before the stipulated period of 5 years.

In case of the remaining employees, the amount as per the formula exceeds ₹ 10,00,000 over the expected period of service of 10 years, and the amount of the threshold of ₹ 10,00,000 is reached at the end of 8 years i.e. ₹ 1,25,000 (₹ 10,00,000 divided by 8) is attributed to each of the first 8 years. In this case, no benefit is attributed to subsequent two years. This is because service beyond 8 years will lead to no material amount of further benefits.

*****

1.9.3 Actuarial Assumptions

- Actuarial assumptions are an entity's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits.
- Actuarial assumptions shall be unbiased and mutually compatible.
- Actuarial assumptions are unbiased if they are neither imprudent nor excessively conservative.
- Actuarial assumptions are mutually compatible if they reflect the economic relationships between factors such as inflation, salary increment rate and discount rates.

  For example, all assumptions which depend on a particular inflation level (such as assumptions about interest rates and salary and benefit increases) in any given future period assume the same inflation level in that period.
- Actuarial assumptions comprise:

  (a) **demographic assumptions** about the future characteristics of current and former employees (and their dependants) who are eligible for benefits. Demographic assumptions deal with matters such as:

    (i) mortality, both during and after employment;

    (ii) rates of employee turnover, disability and early retirement;

    (iii) the proportion of plan members with dependants who will be eligible for benefits;

    (iv) the proportion of plan members who will select each form of payment option available under the plan terms; and

    (v) claim rates under medical plans; and

  (b) **financial assumptions,** dealing with items such as:

    (i) the discount rate;

    (ii) future salary and benefit levels;

    (iii) in the case of medical benefits, future medical costs, including claim handling costs (i.e. the costs that will be incurred in processing and resolving claims, including legal and adjuster's fees); and

(iv) taxes payable by the plan on contributions relating to service before the reporting date or on benefits resulting from that service.

- An entity determines discount rate and other financial assumptions in nominal (stated) terms unless estimates in real (inflation-adjusted) terms are more reliable. For example, in a hyperinflationary economy, or where the benefit is index-linked and there is a deep market in index-linked bonds of the same currency and term.
- Financial assumptions are based on market expectations, at the end of the reporting period, for the period over which the obligations are to be settled.

1.9.3.1 Actuarial Assumptions: Mortality and Discount Rate

1. Mortality Assumptions

Entity is required to determine its mortality assumptions by reference to its best estimate of the mortality of plan members both during and after employment.

In order to estimate the ultimate cost of the benefit an entity shall takes into consideration the expected changes in mortality, for example by modifying standard mortality tables with estimates of mortality improvements.

2. Discount Rate Assumptions

- The rate which is used to discount post-employment benefit obligations (both funded and unfunded) is **determined by reference to market yields on government bonds** at the end of the reporting period.
- **Subsidiaries, associates, joint ventures and branches domiciled outside India** shall discount post-employment benefit obligations arising on account of post-employment benefit plans using the rate **determined by reference to market yields** at the end of the reporting period **on high quality corporate bonds**.
- In case, such subsidiaries, associates, joint ventures and branches are domiciled in countries **where there is no deep market in such bonds, the market yields** (at the end of the reporting period) **on government bonds** of that country **shall be used**.
- The currency and term of the government bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations as the pay-outs will happen in same currency only.
- The discount rate reflects the estimated timing of benefit payments/time value of money and not the actuarial or investment risk. This also does not reflect entity-specific credit risk borne by the entity's creditors.
- Thus, practically speaking, it is achieved by an entity by applying a single weighted average discount rate that reflects the estimated timing and amount of benefit payments and the currency in which the benefits are to be paid.

- Where there is no deep market in government bonds with a sufficiently long maturity to match the estimated maturity of all the benefit payments, an entity uses current market rates of the appropriate term to discount shorter-term payments, and estimates the discount rate for longer maturities by extrapolating current market rates along the yield curve.
- **Interest cost is computed by multiplying the discount rate as determined at the start of the period by the present value of the defined benefit obligation** throughout that period and taking account of any material changes in the obligation.

1.9.3.2 Actuarial Assumptions: Salaries, Benefits and Medical Costs

- Defined benefit obligations shall be measured on a basis that reflects:

  (a) the benefits set out in the terms of the plan (or resulting from any constructive obligation that goes beyond those terms) at the end of the reporting period;

  (b) estimated future salary increases;

  (a) the effect of any limit on the employer's share of the cost of the future benefits;

  (b) contributions from employees or third parties that reduce the ultimate cost to the entity of those benefits; and

  (e) estimated future changes in the level of any state benefits that affect the benefits payable under a defined benefit plan, if, and only if, either:

    (i) those changes were enacted before the end of the reporting period; or

    (ii) past history, or other reliable evidence, indicates that those state benefits will change in some predictable manner, for example, in line with future changes in general price levels or general salary levels.

- Estimates of future salary increases are calculated after taking account inflation, seniority, promotion and other relevant factors, such as supply and demand in the employment market.
- The formal terms of a plan (or a constructive obligation that goes beyond those terms) require an entity to change benefits in future periods; the measurement of the obligation reflects those changes.

  Examples can be when

  (a) entity has a history of increasing benefits, for example, to mitigate the effects of inflation, and there is no indication that this practice will change in the future;

  (b) the entity is obliged, by either the formal terms of a plan (or a constructive obligation that goes beyond those terms) or legislation, to use any surplus in the plan for the benefit of plan participants; or

(c) benefits vary in response to a performance target or other criteria. For example, the terms of the plan may state that it will pay reduced benefits or require additional contributions from employees if the plan assets are insufficient. The measurement of the obligation reflects the best estimate of the effect of the performance target or other criteria.

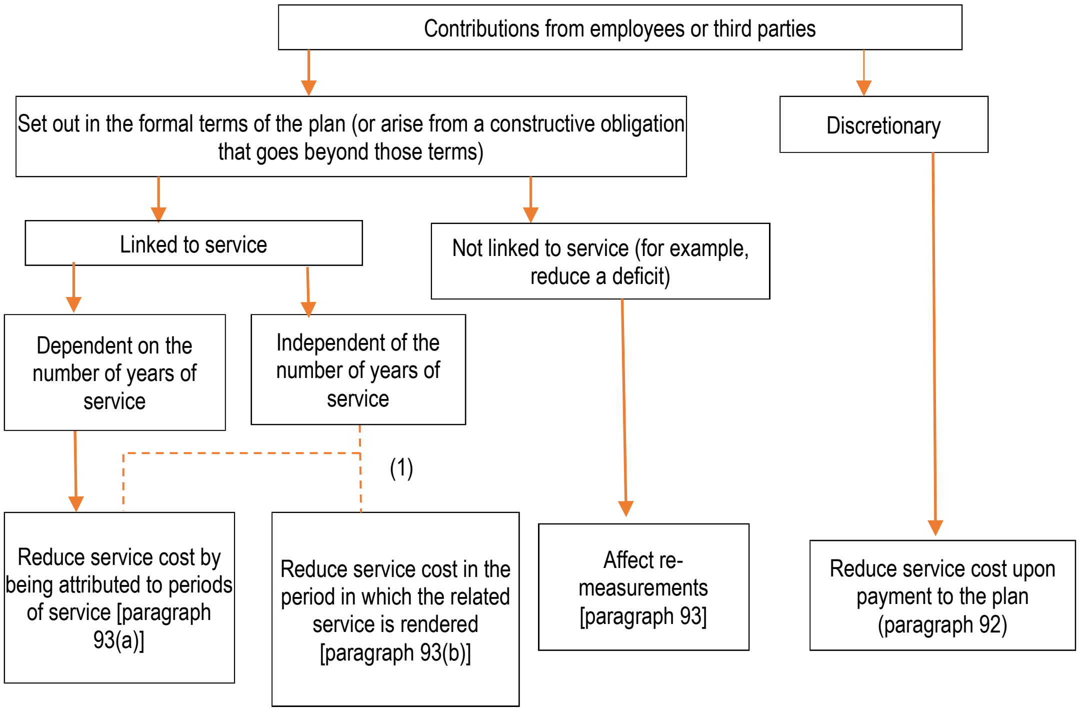
❖ Some post-employment benefits are linked to variables such as the level of state retirement benefits or state medical care. The measurement of such benefits reflects expected changes in such variables, based on past history and other reliable evidence.

❖ Assumptions about medical costs shall take into account estimated future changes in the cost of medical services, resulting from both inflation and specific changes in medical costs.

❖ Post-employment medical benefits measurement requires assumptions about the level and frequency of future claims and the cost of meeting those claims. Future medical costs are estimated on the basis of historical data about the entity's own experience and in case some more data is required to analyse the data, this data is gathered as historical data from other entities, insurance companies, medical providers or other sources. Estimates of future medical costs would consider the effect of technological advances, changes in health care utilisation or delivery patterns and changes in the health status of plan participants.

❖ The level and frequency of claims is particularly sensitive to the age, health status and sex of employees (and their dependants) and may be sensitive to other factors such as geographical location. Hence, this historical data is adjusted to the extent that the demographic mix of the population which differs from that of the population used as a basis for the historical data. Also it requires an adjustment where there is reliable evidence that historical trends will not continue.

❖ Some post-employment health care plans also require employees to contribute to the medical costs covered by the plan and thus estimates of future medical costs also take in account of any such contributions which are based on the terms of the plan at the end of the reporting period (or based on any constructive obligation that goes beyond those terms). Changes in those employee contributions result in past service cost or, where applicable, curtailments. The cost of meeting claims may be reduced by benefits from state or other medical providers.



(1) This dotted arrow means that an entity is permitted to choose either accounting.

1.9.3.3 Past Service Cost and Gains and Losses on Settlement

❖ ***When determining past service cost, or a gain or loss on settlement, an entity shall remeasure the net defined benefit liability (asset) using the current fair value of plan assets and current actuarial assumptions (including current market interest rates and other current market prices) reflecting:***

- ***the benefits offered under the plan and the plan assets before the plan amendment, curtailment or settlement; and***
- ***the benefits offered under the plan and the plan assets after the plan amendment, curtailment or settlement.***

❖ An entity need not distinguish between past service cost resulting from a plan amendment, past service cost resulting from a curtailment and a gain or loss on settlement if these transactions occur together. In some cases, a plan amendment occurs before a settlement, such as when an entity changes the benefits under the plan and settles the amended benefits later. In those cases, an entity recognises past service cost before any gain or loss on settlement.

❖ ***When a plan amendment, curtailment or settlement occurs, an entity shall recognise and measure any past service cost, or a gain or loss on settlement. In doing so, an entity shall not consider the effect of the asset ceiling. An entity shall then determine***

the effect of the asset ceiling after the plan amendment, curtailment or settlement and shall recognise any change in that effect.

- A settlement occurs together with a plan amendment and curtailment if a plan is terminated with the result that the obligation is settled and the plan ceases to exist. However, the termination of a plan is not a settlement if the plan is replaced by a new plan that offers benefits that are, in substance, the same.

1.9.3.3.1 Past Service Cost

- Change in the present value of the defined benefit obligation resulting from a plan amendment or curtailment is known as past service cost.
- An entity shall recognise past service cost as an expense at the earlier of the following dates:
  (a) when the plan amendment or curtailment occurs; and
  (b) when the entity recognises related restructuring costs (refer Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets) or termination benefits.
- Plan amendment happens when an entity introduces, or withdraws, a defined benefit plan or changes the benefits payable under an existing defined benefit plan.
- Curtailment arises when an entity significantly reduces the number of employees covered by a plan. A curtailment may arise from an isolated event, such as the closing of a plant, discontinuance of an operation or termination or suspension of a plan.
- Past service cost may be either positive (when benefits are introduced or changed so that the present value of the defined benefit obligation increases) or negative (when benefits are withdrawn or changed so that the present value of the defined benefit obligation decreases).
- Past service cost excludes the following:
  (a) the effect of differences between actual and previously assumed salary increases on the obligation to pay benefits for service in prior years (there is no past service cost because actuarial assumptions allow for projected salaries);
  (b) underestimates and overestimates of discretionary pension increases when an entity has a constructive obligation to grant such increases (there is no past service cost because actuarial assumptions allow for such increases);
  (c) estimates of benefit improvements that result from actuarial gains that have been recognised in the financial statements if the entity is obliged, by either the formal terms of a plan (or a constructive obligation that goes beyond those terms) or legislation, to use any surplus in the plan for the benefit of plan participants, even if the benefit increase has not yet been formally awarded; and
  (d) the increase in vested benefits when, in the absence of new or improved benefits, employees complete vesting requirements (there is no past service cost because the entity recognised the estimated cost of benefits as current service cost as the service was rendered); and

1.9.3.3.2 Gains and losses on settlement

- A settlement occurs when an entity enters into a transaction that eliminates all further legal or constructive obligation for part or all of the benefits provided under a defined benefit plan (other than a payment of benefits to, or on behalf of, employees in accordance with the terms of the plan and included in the actuarial assumptions).

  For example, a one-off transfer of significant employer obligations under the plan to an insurance company through the purchase of an insurance policy is a settlement; a lump sum cash payment, under the terms of the plan, to plan participants in exchange for their rights to receive specified post-employment benefits is not.

- The gain or loss on a settlement is the difference between:

  (a) the present value of the defined benefit obligation being settled, as determined on the date of settlement; and

  (b) the settlement price, including any plan assets transferred and any payments made directly by the entity in connection with the settlement.

- Gain or loss on the settlement of a defined benefit plan is recognised by the entity when the settlement occurs.

1.10 RECOGNITION AND MEASUREMENT: PLAN ASSETS

1.10.1 Fair Value of Plan Assets

- The fair value of any plan assets is deducted from the present value of the defined benefit obligation in determining the deficit or surplus.

- Plan assets exclude unpaid contributions due from the reporting entity to the fund, as well as any non-transferable financial instruments issued by the entity and held by the fund. Plan assets are reduced by any liabilities of the fund that do not relate to employee benefits, for example, trade and other payables and liabilities resulting from derivative financial instruments.

- Where plan assets include qualifying insurance policies that exactly match the amount and timing of some or all of the benefits payable under the plan, the fair value of those insurance policies is deemed to be the present value of the related obligations, (subject to any reduction required if the amounts receivable under the insurance policies are not recoverable in full).

1.10.2 Reimbursements

- An entity will recognise its right to reimbursement as a separate asset when, and only when, it is virtually certain that another party will reimburse some or all of the expenditure required to settle a defined benefit obligation. The assets are measured at fair value by the entity and in all other respects, an entity shall treat that asset in the same way as plan assets. In the statement of profit and loss, the expense relating to a defined benefit plan may be presented net of the amount recognised for a reimbursement.

- Sometimes, an entity is able to look to another party, such as an insurer, to pay part or all of the expenditure required to settle a defined benefit obligation. An entity accounts for qualifying insurance policies in the same way as for all other plan assets. When an insurance policy is not a qualifying insurance policy, that insurance policy is not a plan asset.
- In such a scenario, an entity recognises its right to reimbursement under the insurance policy as a separate asset, rather than as a deduction in determining the defined benefit liability and in all other respects, the entity treats that asset in the same way as plan assets.
- If the right to reimbursement arises under an insurance policy that exactly matches the amount and timing of some or all of the benefits payable under a defined benefit plan, the fair value of the reimbursement right is deemed to be the present value of the related obligation.

1.11 COMPONENTS OF DEFINED BENEFIT COST

- An entity is required to recognise the components of defined benefit cost, except to the extent that another Ind AS (refer Ind AS 2 and Ind AS 16) requires or permits their inclusion in the cost of an asset, as follows:
  - (a) service cost in profit or loss;
  - (b) net interest on the net defined benefit liability (asset) in profit or loss; and
  - (c) remeasurements of the net defined benefit liability (asset) in other comprehensive income.
- Remeasurements of the net defined benefit liability (asset) recognised in other comprehensive income shall not be reclassified to profit or loss in a subsequent period. However, the entity may transfer those amounts recognised in other comprehensive income within equity.

Current service cost

- ***An entity shall determine current service cost using actuarial assumptions determined at the start of the annual reporting period. However, if an entity remeasures the net defined benefit liability (asset), as discussed above, it shall determine current service cost for the remainder of the annual reporting period after the plan amendment, curtailment or settlement using the actuarial assumptions used to remeasure the net defined benefit liability (asset) in accordance with paragraph 99(b) of Ind AS 19 (i.e. reflecting the benefits offered under the plan and the plan assets after the plan amendment, curtailment or settlement).***

1.11.1 Net interest on the net defined benefit liability (asset)

- ***An entity shall determine net interest on the net defined benefit liability (asset) by multiplying the net defined benefit liability (asset) by the discount rate.***
- ***To determine net interest in accordance with paragraph mentioned above, an entity shall use the net defined benefit liability (asset) and the discount rate determined at the start of the annual reporting period. However, if an entity remeasures the net defined benefit liability (asset), the entity shall determine net interest for the remainder of the annual reporting period after the plan amendment, curtailment or settlement using:***

  (a) the net defined benefit liability (asset) determined in accordance with paragraph 99(b) of Ind AS 19 (i.e. reflecting the benefits offered under the plan and the plan assets after the plan amendment, curtailment or settlement); and

  (b) the discount rate used to remeasure the net defined benefit liability (asset) in accordance with paragraph 99(b) of Ind AS 19 (i.e. reflecting the benefits offered under the plan and the plan assets after the plan amendment, curtailment or settlement).

  In applying this paragraph, the entity shall also take into account any changes in the net defined benefit liability (asset) during the period resulting from contributions or benefit payments.
- Net interest on the net defined benefit liability (asset) can be viewed as comprising interest income on plan assets, interest cost on the defined benefit obligation and interest on the effect of the asset ceiling.
- Interest income on plan assets is a component of the return on plan assets, and is determined by multiplying the fair value of the plan assets by the discount rate. ***An entity shall determine the fair value of the plan assets at the start of the annual reporting period. However, if an entity remeasures the net defined benefit liability (asset), the entity shall determine interest income for the remainder of the annual reporting period after the plan amendment, curtailment or settlement using the plan assets used to remeasure the net defined benefit liability (asset) in accordance with paragraph 99(b) of Ind AS 19 (i.e. reflecting the benefits offered under the plan and the plan assets after the plan amendment, curtailment or settlement). In applying this paragraph, the entity shall also take into account any changes in the plan assets held during the period resulting from contributions or benefit payments.***
- The difference between the interest income on plan assets and the return on plan assets is included in the remeasurement of the net defined benefit liability (asset).
- Interest on the effect of the asset ceiling is part of the total change in the effect of the asset ceiling, and is determined by multiplying the effect of the asset ceiling by the discount rate. ***An entity shall determine the effect of the asset ceiling at the start of the annual reporting period. However, if an entity remeasures the net defined benefit liability***

(asset), the entity shall determine interest on the effect of the asset ceiling for the remainder of the annual reporting period after the plan amendment, curtailment or settlement taking into account any change in the effect of the asset ceiling. The difference between interest on the effect of the asset ceiling and the total change in the effect of the asset ceiling is included in the remeasurement of the net defined benefit liability (asset).

1.11.2 Remeasurements of the net defined benefit liability (asset)

❖ Remeasurements of the net defined benefit liability (asset) comprise:

(a) actuarial gains and losses;

(b) the return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset); and

(c) any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset).

❖ Actuarial gains and losses occur from increases or decreases in the present value of the defined benefit obligation because of changes in actuarial assumptions and experience adjustments. Following are the few causes of actuarial gains and losses:

(a) unexpectedly high or low rates of employee turnover, early retirement or mortality or of increases in salaries, benefits (if the formal or constructive terms of a plan provide for inflationary benefit increases) or medical costs;

(b) the effect of changes to assumptions concerning benefit payment options;

(c) the effect of changes in estimates of future employee turnover, early retirement or mortality or of increases in salaries, benefits (if the formal or constructive terms of a plan provide for inflationary benefit increases) or medical costs; and

(d) the effect of changes in the discount rate.

❖ Actuarial gains and losses does not include changes in the present value of the defined benefit obligation because of the introduction, amendment, curtailment or settlement of the defined benefit plan, or changes to the benefits payable under the defined benefit plan. Rather such changes shall result in past service cost or gains or losses on settlement.

❖ In measuring the return on plan assets, an entity deducts the costs of managing the plan assets and any tax payable by the plan itself, other than tax included in the actuarial assumptions used to measure the defined benefit obligation. Other administration costs are not deducted from the return on plan assets.

Illustration 11

RKA Private Ltd is an old company established in 19XX. The company started with a very small capital base and today it is one of the leading companies in India in its industry. The company *has an annual turnover of ₹ 11,000 crores and planning to get listed in the next year.*

The company has a large employee base. The company provided a defined benefit plan to its employees. Following is the information relating to the balances of the fund's assets and liabilities as at 1st April, 20X1 and 31st March, 20X2. *₹ in lacs*

Particulars	***1st April, 20X1***	***31st March, 20X2***
Present value of benefit obligation	*1,400*	*1,580*
Fair value of plan assets	*1,140*	*1,275*

For the financial year ended 31st March, 20X2, service cost was ₹ 55 lacs. The company made a contribution of an amount of ₹ 111 lacs to the plan. No benefits were paid during the year.

Consider a discount rate of 8%.

You are required to -

(a) Compute the balance(s) of the company to be included its balance sheet as on 31st March, 20X2 and amounts to be recognized in the statement of profit and loss and other comprehensive income for the year ended 31st March, 20X2.

(b) Give the journal entries in respect of amount(s) to be recognized.

Solution

(a) Extract of the Balance Sheet of RKA Private Ltd as at 31st March, 20X2

	₹ in lacs
Closing net defined liability (1,580 – 1,275) lacs	305

Extract of the Statement of Profit or Loss of RKA Private Ltd for the year ended 31st March, 20X2

Particulars	**₹ in lacs**
Service cost	55
Net interest ***(Refer W.N.1)***	21
Profit or loss	**76**
Other comprehensive income:	
Remeasurements ***(Refer W.N.2)***	80
Total	**156**

(b) Journal entries in the books of RKA Private Ltd

Particulars		**₹ in lacs**	**₹ in lacs**
Profit & Loss	Dr.	76	
Other comprehensive income	Dr.	80	
To Cash (Contribution)			111
To Net defined benefit liability ***(Refer WN 3)***			45

Working Notes:

1. **Computation of Net interest taken to the Statement of Profit or Loss**

   = Discount rate x Opening net defined benefit liability

   = 8% x (1,400 – 1,140) lacs

   = 8% x 260 lacs

   = 21 lacs (Rounded off to nearest lacs)

2. **Computation of Remeasurements**

   Actuarial gain or loss on defined benefit liability:

Particulars	₹ in lacs
Opening balance of liability	1,400
Current service cost	55
Interest on opening liability (1,400 x 8%)	112
Actuarial loss (Bal. fig)	13
Closing balance of liability	**1,580**

Actual return on plan assets:

Particulars	₹ in lacs
Opening balance of asset	1,140
Cash contribution	111
Actual return (Bal. fig)	24
Closing balance of asset	**1,275**

Net interest on opening balance of plan asset = ₹ 91 lacs (i.e. ₹ 1,140 lacs x 8%) (Rounded off to nearest lacs)

Hence there is a decrease in plan assets due to remeasurement for which computation is as follows:

Actual Return – Net interest on opening plan asset

= ₹ 24 lacs – ₹ 91 lacs = ₹ 67 lacs.

Net remeasurement would be computed as follows:

Actuarial loss on liability + Loss on return

= ₹ 13 lacs + ₹ 67 lacs = ₹ 80 lacs.

3. **Computation of increase/ decrease in net defined benefit liability:**

Particulars	₹ in lacs
Opening net liability (₹ 1,400 lacs – ₹ 1,140 lacs)	260
Closing net liability (₹ 1,580 lacs – ₹ 1,275 lacs)	305
Increase in liability	**45**

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1.12 PRESENTATION

1.12.1 Offset

- An asset relating to one plan will be offset against a liability relating to another plan when, and only when, the entity:

  (a) has a legally enforceable right to use a surplus in one plan to settle obligations under the other plan; and

  (b) there is an intention either to settle the obligations on a net basis, or to realise the surplus in one plan and settle its obligation under the other plan simultaneously.

- The offsetting criteria are similar to those established for financial instruments in Ind AS 32, Financial Instruments: Presentation.

1.12.2 Current/Non-current Distinction

This Standard does not specify whether an entity should distinguish current and non-current portions of assets and liabilities arising from post-employment benefits.

1.12.3 Components of Defined Benefit Costs

This Standard does not specify how an entity should present current service cost and net interest cost on net defined liability (asset). An entity presents those components in accordance with Ind AS 1 Presentation of Financial Statements.

1.13 DISCLOSURE

An entity shall disclose information that enables users of financial statements to evaluate the nature of its defined benefit plans and the financial effects of changes in those plans during the period.

1.13.1 General

- An entity shall disclose information that:

  (a) explains the characteristics of its defined benefit plans and risks associated with them;

(b) identifies and explains the amounts in its financial statements arising from its defined benefit plans; and

(c) describes how its defined benefit plans may affect the amount, timing and uncertainty of the entity's future cash flows.

❖ To meet these objectives, an entity should have regard to all the following:

(a) the level of detail necessary to satisfy the disclosure requirements;

(b) how much emphasis to place on each of the various requirements;

(c) how much aggregation or disaggregation to undertake; and

(d) whether users of financial statements need additional information to evaluate the quantitative information disclosed.

❖ If the disclosures provided in accordance with Ind AS 19 and other Ind AS are insufficient to meet the required objectives, additional information necessary to meet those objectives should be disclosed. For example, an entity might present an analysis of the present value of the defined benefit obligation that distinguishes the nature, characteristics and risks of the obligation. Such a disclosure could distinguish:

(a) between amounts owing to active members, deferred members, and pensioners;

(b) between vested benefits and accrued but not vested benefits; and

(c) between conditional benefits, amounts attributable to future salary increases and other benefits.

❖ An entity is required to assess whether all or some disclosures should be disaggregated to distinguish plans or groups of plans with materially different risks. For example, an entity may disaggregate disclosure about plans showing one or more of the following features:

(a) different geographical locations;

(b) different characteristics such as flat salary pension plans, final salary pension plans or postemployment medical plans;

(c) different regulatory environments;

(d) different reporting segments; and

(e) different funding arrangements (e.g. wholly unfunded, wholly or partly funded).

1.13.2 Characteristics of defined benefit plans and risks associated with them

An entity shall disclose:

(a) information about the characteristics of its defined benefit plans, including:

(i) the nature of the benefits provided by the plan (e.g. final salary defined benefit plan or contribution-based plan with guarantee);

(ii) a description of the regulatory framework in which the plan operates (e.g. the level of any minimum funding requirements, and any effect of the regulatory framework on the plan, such as the asset ceiling); and

(iii) a description of any other entity's responsibilities for the governance of the plan (e.g. responsibilities of trustees or of board members of the plan).

(b) a description of the risks to which the plan exposes the entity, focused on any unusual, entity specific or plan-specific risks, and of any significant concentrations of risk. For example, if plan assets are invested primarily in one class of investments (e.g. property), the plan may expose the entity to a concentration of property market risk; and

(c) a description of any plan amendments, curtailments and settlements.

1.13.3 Explanation of amounts in the financial statements

❖ An entity shall provide a reconciliation from the opening balance to the closing balance for each of the following, if applicable:

(a) the net defined benefit liability (asset), showing separate reconciliations for:

(i) plan assets;

(ii) the present value of the defined benefit obligation; and

(iii) the effect of the asset ceiling; and

(b) any reimbursement rights. An entity shall also describe the relationship between any reimbursement right and the related obligation.

❖ Each reconciliation listed in paragraph 140 shall show each of the following, if applicable:

(a) current service cost;

(b) interest income or expense;

(c) remeasurements of the net defined benefit liability (asset), showing separately:

(i) the return on plan assets, excluding amounts included in interest in interest income or expense;

(ii) actuarial gains and losses arising from changes in demographic assumptions;

(iii) actuarial gains and losses arising from changes in financial assumptions; and

(iv) changes in the effect of limiting a net defined benefit asset to the asset ceiling, excluding amounts included in interest income or expense. An entity shall also disclose how it determined the maximum economic benefit available, i.e. whether those benefits would be in the form of refunds, reductions in future contributions or a combination of both;

(d) past service cost and gains and losses arising from settlements. If permitted by the standard past service cost and gains and losses arising from settlements need not be distinguished if they occur together;

(e) the effect of changes in foreign exchange rates;

(f) contributions to the plan, showing separately those by the employer and by plan participants;

(g) payments from the plan, showing separately the amount paid in respect of any settlements; and

(h) the effects of business combinations and disposals.

❖ The fair value of the plan assets shall be disaggregated into classes that distinguish the nature and risks of those assets, subdividing each class of plan asset into those that have a quoted market price in an active market (as defined in Ind AS 113, *Fair Value Measurement*) and those that do not.

For example, and considering the level of general disclosures, an entity might distinguish between:

(a) cash and cash equivalents;

(b) equity instruments (segregated by industry type, company size, geography etc);

(c) debt instruments (segregated by type of issuer, credit quality, geography etc);

(d) real estate (segregated by geography etc);

(e) derivatives (segregated by type of underlying risk in the contract, for example, interest rate contracts, foreign exchange contracts, equity contracts, credit contracts, longevity swaps etc);

(f) investment funds (segregated by type of fund);

(g) asset-backed securities; and

(h) structured debt.

❖ An entity shall disclose:

(a) the fair value of the entity's own transferable financial instruments held as plan assets; and

(b) the fair value of plan assets that are property occupied by, or other assets used by, the entity.

❖ An entity shall disclose the significant actuarial assumptions used to determine the present value of the defined benefit obligation. Such disclosure shall be in absolute terms (e.g. as an absolute percentage, and not just as a margin between different percentages and other variables). When an entity provides disclosures in total for a grouping of plans, it shall provide such disclosures in the form of weighted averages or relatively narrow ranges.

1.13.4 Amount, timing and uncertainty of future cash flows

- An entity shall disclose:
  - (a) a sensitivity analysis for each significant actuarial assumption as of the end of the reporting period, showing how the defined benefit obligation would have been affected by changes in the relevant actuarial assumption that were reasonably possible at that date;
  - (b) the methods and assumptions used in preparing these sensitivity analyses and the limitations of those methods; and
  - (c) changes from the previous period in the methods and assumptions used in preparing the sensitivity analyses, and the reasons for such changes.
- An entity shall disclose a description of any asset-liability matching strategies used by the plan or the entity, including the use of annuities and other techniques, such as longevity swaps, to manage risk.
- To provide an indication of the effect of the defined benefit plan on the entity's future cash flows, an entity shall disclose:
  - (a) a description of any funding arrangements and funding policy that affect future contributions;
  - (b) the expected contributions to the plan for the next annual reporting period;
  - (c) information about the maturity profile of the defined benefit obligation. This will include the weighted average duration of the defined benefit obligation and may include other information about the distribution of the timing of benefit payments, such as a maturity analysis of the benefit payments.

1.13.5 Multi-employer plans

If an entity participates in a multi-employer defined benefit plan, it shall disclose:

(a) a description of the funding arrangements, including the method used to determine the entity's rate of contributions and any minimum funding requirements;

(b) a description of the extent to which the entity can be liable to the plan for other entities' obligations under the terms and conditions of the multi-employer plan; and

(c) a description of any agreed allocation of a deficit or surplus on:

- (i) wind-up of the plan; or
- (ii) the entity's withdrawal from the plan.

1.13.6 Disclosure requirements in other Ind AS

- Where required by Ind AS 24 *Related Party Disclosures,* an entity discloses information about:
  - (a) related party transactions with post-employment benefit plans; and
  - (b) post-employment benefits for key management personnel.
- Where required by Ind AS 37 *Provisions, Contingent liabilities and Contingent Assets*, an entity discloses information about contingent liabilities arising from post-employment benefit obligations.

1.14 OTHER LONG-TERM EMPLOYEE BENEFITS

- Other long-term employee benefits are those employee benefits which are not expected to be settled wholly before twelve months after the end of the annual reporting period.
- Other long-term employee benefits include, for example:
  - (a) long-term paid absences such as long-service or sabbatical leave;
  - (b) jubilee or other long-service benefits;
  - (c) long-term disability benefits;
  - (d) profit-sharing and bonuses; and
  - (e) deferred remuneration.
- The measurement of other long-term employee benefits is not usually subject to the same degree of uncertainty as the measurement of post-employment benefits. It is also there that the introduction of, or changes to, other long-term employee benefits rarely causes a material amount of past service cost. This method does not recognise remeasurements in other comprehensive income as required under the accounting required for post-employment benefits.

1.14.1 Recognition and Measurement

- For other long-term employee benefits, an entity shall recognise the net total of the following amounts in profit or loss, except to the extent that another Standard requires or permits their inclusion in the cost of an asset:
  - (a) service cost;
  - (b) net interest on the net defined benefit liability (asset); and
  - (c) remeasurements of the net defined benefit liability (asset).
- One form of other long-term employee benefit is long-term disability benefit. If the level of benefit depends on the length of service, an obligation arises when the service is rendered.

Measurement of that obligation reflects the probability that payment will be required and the length of time for which payment is expected to be made. If the level of benefit is the same for any disabled employee regardless of years of service, the expected cost of those benefits is recognised when an event occurs that causes a long-term disability.

1.14.2 Disclosure

Though this Standard does not require specific disclosures about other long-term employee benefits, other Standards may require disclosures.

For example:

a. Where the expense resulting from such benefits is material and so would require disclosure in accordance with Ind AS 1.

b. When required by Ind AS 24, an entity discloses information about other long-term employee benefits for key management personnel.

1.15 TERMINATION BENEFITS

❖ This Standard deals with termination benefits separately from other employee benefits because the event which gives rise to an obligation is the termination of employment rather than employee service.

❖ Termination benefits results from either:

(a) an entity's decision to terminate the employment or

(b) an employee's decision to accept an entity's offer of benefits in exchange for termination of employment.

1.15.1 Recognition

❖ An entity is required to **recognise** a liability and expense for termination benefits **at the earlier of the following dates**:

(a) when the entity can no longer withdraw the offer of those benefits; and

(b) when the entity recognises costs for a restructuring which is within the scope of Ind AS 37 and involves the payment of termination benefits.

❖ For **termination benefits** payable **as a result of an employee's decision to accept an offer of** benefits in exchange for the **termination of employment**, the **time when an entity can no longer withdraw the offer** of termination benefits **is the earlier of**:

(a) when the employee accepts the offer; and

(b) when a restriction (eg a legal, regulatory or contractual requirement or other restriction) on the entity's ability to withdraw the offer takes effect.

- For termination benefits payable as a result of an entity's decision to terminate an employee's employment, the entity can no longer withdraw the offer when the entity has communicated to the affected employees a plan of termination meeting all of the following criteria:
  - (a) Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made.
  - (b) The plan identifies the number of employees whose employment is to be terminated, their job classifications or functions and their locations (but the plan need not identify each individual employee) and the expected completion date.
  - (c) The plan establishes the termination benefits that employees will receive in sufficient detail that employees can determine the type and amount of benefits they will receive when their employment is terminated.
- Where an entity recognises termination benefits, the entity may also have to account for a curtailment of retirement benefits or other employee benefits.

1.15.2 Measurement

An entity shall measure termination benefits on initial recognition, and shall measure and recognise subsequent changes, in accordance with the nature of the employee benefit, provided that if the termination benefits are an enhancement to post-employment benefits, the entity shall apply the requirements for post-employment benefits. Otherwise:

(a) If the termination benefits are expected to be settled wholly before twelve months after the end of the annual reporting period in which the termination benefit is recognised, the entity shall apply the requirements for short-term employee benefits.

(b) If the termination benefits are not expected to be settled wholly before twelve months after the end of the annual reporting period, the entity shall apply the requirements for other long term employee benefits.

Example on Termination Benefits

As a result of a recent acquisition, an entity plans to close a factory in ten months and, at that time, terminate the employment of all of the remaining employees at the factory. Because the entity needs the expertise of the employees at the factory to complete some contracts, it announces a plan of termination as follows.

Each employee who stays and renders service until the closure of the factory will receive on the termination date a cash payment of ₹ 30,000. Employees leaving before closure of the factory will receive ₹ 10,000.

There are 120 employees at the factory. At the time of announcing the plan, the entity expects 20 of them to leave before closure. Therefore, the total expected cash outflows under the plan are ₹ 3,200,000 (ie 20 × ₹ 10,000 + 100 × ₹ 30,000). As required by paragraph 160, the entity accounts for benefits provided in exchange for termination of employment as termination benefits and accounts for benefits provided in exchange for services as short-term employee benefits.

Termination benefits

The benefit provided in exchange for termination of employment is ₹ 10,000. This is the amount that an entity would have to pay for terminating the employment regardless of whether the employees stay and render service until closure of the factory or they leave before closure. Even though the employees can leave before closure, the termination of all employees' employment is a result of the entity's decision to close the factory and terminate their employment (ie all employees will leave employment when the factory closes). Therefore, the entity recognises a liability of ₹ 1,200,000 (ie 120 × ₹ 10,000) for the termination benefits provided in accordance with the employee benefit plan at the earlier of when the plan of termination is announced and when the entity recognises the restructuring costs associated with the closure of the factory.

Benefits provided in exchange for service

The incremental benefits that employees will receive if they provide services for the full ten-month period are in exchange for services provided over that period. The entity accounts for them as short-term employee benefits because the entity expects to settle them before twelve months after the end of the annual reporting period. In this example, discounting is not required, so an expense of ₹ 200,000 (ie ₹ 2,000,000 ÷ 10) is recognised in each month during the service period of ten months, with a corresponding increase in the carrying amount of the liability.

1.15.3 Disclosure

This Standard does not require specific disclosures about termination benefits, other Ind AS may require disclosures.

For example:

a. where required by Ind AS 24 an entity discloses information about termination benefits for key management personnel.

b. Ind AS 1 requires disclosure of employee benefits expense.

1.16 IND AS 19 — THE LIMIT ON A DEFINED BENEFIT ASSET, MINIMUM FUNDING REQUIREMENTS AND THEIR INTERACTION

1.16.1 Background

❖ Ind AS 19 limits the measurement of a defined benefit asset to the lower of the surplus in the defined benefit plant and asset ceiling (i.e. the present value of economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan). Questions have arisen about when refunds or reductions in future contributions should be regarded as available, particularly when a minimum funding requirement exists.

- Minimum funding requirements normally stipulate a minimum amount or level of contributions that must be made to a plan over a given period. Therefore, a minimum funding requirement may limit the ability of the entity to reduce future contributions.
- Further, the limit on the measurement of a defined benefit asset may cause a minimum funding requirement to be onerous. Normally, a requirement to make contributions to a plan would not affect the measurement of the defined benefit asset or liability. This is because the contributions, once paid, will become plan assets and so the additional net liability is nil. However, a minimum funding requirement may give rise to a liability if the required contributions will not be available to the entity once they have been paid.

1.16.2 Scope

This Appendix applies to all post-employment defined benefits and other long-term employee defined benefits. For the purpose of this Appendix, minimum funding requirements are any requirements to fund a post-employment or other long-term defined benefit plan.

1.16.3 Issues

The issues addressed in this Appendix are:

(a) when refunds or reductions in future contributions should be regarded as available in accordance with the definition of the asset ceiling.

(b) how a minimum funding requirement might affect the availability of reductions in future contributions.

(c) when a minimum funding requirement might give rise to a liability.

1.16.4 Principles

1.16.4.1 Availability of a refund or reduction in future contributions

- Availability of a refund or a reduction in future contributions shall be determined in accordance with the terms and conditions of the plan and any statutory requirements in the jurisdiction of the plan.
- An economic benefit is available in the form of a refund or a reduction in future contributions if the entity can realise it at some point during the life of the plan or when the plan liabilities are settled.
- The economic benefit available does not depend on how the entity intends to use the surplus. An entity shall determine the maximum economic benefit that is available from refunds, reductions in future contributions or a combination of both. An entity shall not recognise economic benefits from a combination of refunds and reductions in future contributions based on assumptions that are mutually exclusive.

- In accordance with Ind AS 1, the entity shall disclose information about the key sources of estimation uncertainty at the end of the reporting period that have a significant risk of causing a material adjustment to the carrying amount of the net asset or liability recognised in the balance sheet. This might include disclosure of any restrictions on the current realisability of the surplus or disclosure of the basis used to determine the amount of the economic benefit available.

1.16.4.2 The economic benefit available as a refund

1. The right to a refund

- A refund is available to an entity only if the entity has an unconditional right to a refund:
  - (a) during the life of the plan, without assuming that the plan liabilities must be settled in order to obtain the refund (e.g., in some jurisdictions, the entity may have a right to a refund during the life of the plan, irrespective of whether the plan liabilities are settled); or
  - (b) assuming the gradual settlement of the plan liabilities over time until all members have left the plan; or
  - (c) assuming the full settlement of the plan liabilities in a single event (i.e., as a plan wind-up).
- An unconditional right to a refund can exist whatever the funding level of a plan at the end of the reporting period.
- If the entity's right to a refund of a surplus depends on the occurrence or non-occurrence of one or more uncertain future events not wholly within its control, the entity does not have an unconditional right and shall not recognise an asset.

2. Measurement of the economic benefit

- An entity shall measure the economic benefit available as a refund as the amount of the surplus at the end of the reporting period (being the fair value of the plan assets less the present value of the defined benefit obligation) that the entity has a right to receive as a refund, less any associated costs.

  For instance, if a refund would be subject to a tax other than income tax, an entity shall measure the amount of the refund net of the tax.
- In measuring the amount of a refund available when the plan is wound up, an entity shall include the costs to the plan of settling the plan liabilities and making the refund.

  For example, an entity shall deduct professional fees if these are paid by the plan rather than the entity, and the costs of any insurance premiums that may be required to secure the liability on wind-up.
- If the amount of a refund is determined as the full amount or a proportion of the surplus, rather than a fixed amount, an entity shall make no adjustment for the time value of money, even if the refund is realisable only at a future date.

1.16.4.3 The economic benefit available as a contribution reduction

- The economic benefit available as a reduction in future contributions is the future service cost to the entity for each period over the shorter of the expected life of the plan and the expected life of the entity, if there is no minimum funding requirement for contributions relating to future service. The future service cost to the entity excludes amounts that will be borne by employees.
- An entity shall determine the future service costs using assumptions consistent with those used to determine the defined benefit obligation and with the situation that exists at the end of the reporting period. Therefore, an entity shall assume no change to the benefits to be provided by a plan in the future can be assumed by the entity until the plan is amended and shall assume a stable workforce in the future unless the entity makes a reduction in the number of employees covered by the plan. In the latter case, the assumption about the future workforce shall include the reduction.

1.16.4.4 The effect of a minimum funding requirement on the economic benefit available as a reduction in future contributions

- An entity shall analyse any minimum funding requirement at a given date into contributions that are required to cover

  (a) any existing shortfall for past service on the minimum funding basis; and

  (b) future service.

    - o Contributions to cover any existing shortfall on the minimum funding basis in respect of services already received do not affect future contributions for future service. They may give rise to a liability.
- If there is a minimum funding requirement for contributions relating to the future service, the economic benefit available as a reduction in future contributions is the sum of:

  (a) any amount that reduces future minimum funding requirement contributions for future service because the entity made a prepayment (i.e., paid the amount before being required to do so); and

  (b) the estimated future service cost in each period less the estimated minimum funding requirement contributions that would be required for future service in those periods if there were no prepayment as described in (a).
- An entity shall estimate the future minimum funding requirement contributions for future service taking into account the effect of any existing surplus determined using the minimum funding basis but excluding the prepayment. An entity shall use assumptions consistent with the minimum funding basis and, for any factors not specified by that basis, assumptions consistent with those used to determine the defined benefit obligation and with the situation that exists at the end of the reporting period. The estimate shall include any changes

expected as a result of the entity paying the minimum contributions when they are due. However, the estimate shall not include the effect of expected changes in the terms and conditions of the minimum funding basis that are not substantively enacted or contractually agreed at the end of the reporting period.

- When an entity determines the amount, if the future minimum funding requirement contributions for future service exceed the future service cost in any given period, that excess reduces the amount of the economic benefit available as a reduction in future contributions.

1.16.4.6 When a minimum funding requirement may give rise to a liability

- If an entity has an obligation under a minimum funding requirement to pay contributions to cover an existing shortfall on the minimum funding basis in respect of services already received, the entity shall determine whether the contributions payable will be available as a refund or reduction in future contributions after they are paid into the plan.
- To the extent that the contributions payable will not be available after they are paid into the plan, the entity shall recognise a liability when the obligation arises. The liability shall reduce the defined benefit asset or increase the defined benefit liability so that no gain or loss is expected.

1.17 SIGNIFICANT DIFFERENCES IN IND AS 19 VIS-À-VIS AS 15

S. No.	Particulars	Ind AS 19	AS 15
1.	*Constructive Obligations*	In Ind AS 19, employee benefits arising from constructive obligations are also covered	AS 15 does not deal with the same
2.	*Definition of Employee*	Ind AS 19 the term 'employee' includes directors	As per AS 15, the term 'employee' includes whole-time directors
3.	*Other Definitions*	Definitions of short-term employee benefits, other long-term employee benefits, and past service cost is different in Ind AS 19	Different definitions are given in AS 15
4.	*Contractual Agreement between a Multi-employer Plan and its Participants*	Ind AS 19 deals with situations where there is a contractual agreement between a multi-employer plan and its participants that determines how the surplus in	AS 15 does not deal with it

		the plan will be distributed to the participants (or the deficit funded).	
5.	*Participation in a Defined Benefit Plan Sharing Risks Between Various Entities under Common Control*	As per Ind AS 19, participation in a defined benefit plan sharing risks between various entities under common control is a related party transaction for each group entity and some disclosures are required in the separate or individual financial statements of an entity	AS 15 does not contain similar provisions
6.	*Actuarial valuation*	Detailed actuarial valuation to determine the present value of net defined benefit liability (asset) is performed with sufficient regularity so that the amounts recognized in the financial statements do not differ materially from the amounts that would have been determined at the end of the reporting period. Ind AS 19 does not specify sufficient regularity.	Detailed actuarial valuation to determine the present value of defined benefit obligation is carried out at least once every 3 years and fair value of plan assets are determined at each balance sheet date.
7.	*Recognition of Actuarial Gains and Losses*	Ind AS 19 requires that the same shall be recognised in other comprehensive income and should not be recognised in profit or loss.	AS 15 requires recognition of actuarial gains and losses immediately in the profit and loss
8.	*Financial Assumptions*	Ind AS 19 makes it clear that financial assumptions shall be based on market expectations, at the end of the reporting period, for the period over which the obligations are to be settled	AS 15 does not clarify the same
9.	*Discounting of Post-employment Benefit Obligations*	As per Ind AS 19, subsidiaries, associates, joint ventures and branches domiciled outside India shall discount post-employment benefit obligations arising on account of post-employment benefit	As per AS 15, the rate used to discount post-employment benefit obligations should always be determined by reference to market

		plans using the rate determined by reference to market yields at the end of the reporting period on high quality corporate bonds. In case, such subsidiaries, associates, joint ventures and branches are domiciled in countries where there is no deep market in such bonds, the market yields (at the end of the reporting period) on government bonds of that country shall be used.	yields at the balance sheet date on government bond.
10.	*Timing of Recognition of Termination Benefits*	Under Ind AS 19, more guidance has been given for timing of recognition of termination benefits.	Recognition criteria for termination benefits differ from the criteria given in Ind AS 19.
11.	*Contribution from employee or third parties to defined benefit plans*	Provides guidance on accounting for contributions from employees or third parties to defined benefit plans, which are linked to service - both dependent and independent of the number of years of service	No specific guidance
12.	*Guidance on Interaction of Ceiling of Asset Recognition and Minimum Funding Requirement*	Ind AS 19 gives guidance on the interaction of ceiling of asset recognition and minimum funding requirement in the case of defined benefit obligations.	Such guidance is not available in AS 15.

TEST YOUR KNOWLEDGE

Questions

1. An entity has 100 employees, who are each entitled to five working days of paid sick leaves for each year. Unused sick leave may be carried forward for one calendar year. Sick leave is taken first out of the current year's entitlement and then out of any balance brought forward from the previous year (LIFO basis).

   At 31st March, 20X1, the average unused entitlement is two days per employee. The entity expects, on the basis of experience that is expected to continue, that 92 employees will take no more than five days of paid sick leaves in 20X1-20X2 and that the remaining eight employees will take an average of six and a half days each.

   The entity expects that it will pay an additional twelve days of sick pay as a result of the unused entitlement that has accumulated at 31st March, 20X1 (one and a half days each, for eight employees). Would the entity require to recognize any liability in respect of leaves?

2. A plan provides a monthly pension of 0.3% of final salary for each year of service. The pension is payable from the age of 65. What is the current service cost?

3. A plan pays a benefit of ₹ 140 for each year of service, excluding service before the age of 25. The benefits vest immediately. Compute the benefit to be attributed before the age of 25 and after 25?

4. B Pvt. Ltd. has a post-employment medical plan which will reimburse 20% of an employee's post-employment medical costs if the employee leaves after more than ten and less than twenty years of service and 50% of those costs if the employee leaves after twenty or more years of service. How would you measure the benefit to be attributed for the employee service for the last 20 years, 10 and 20 years and within 10 years?

5. Cisca Pvt. Ltd. has a headcount of around 1,000 employees in the organisation in 20X0-20X1. As per the company's policy, the employees are given 35 days of privilege leaves (PL), 15 days of sick leaves (SL) and 10 days of casual leaves. Out of the total PL and sick leaves, 10 PL leaves and 5 sick leaves can be carried forward to next year. On the basis of past trends, it has been noted that 200 employees will take 5 days of PL and 2 days of SL and 800 employees will avail 10 days of PL and 5 days of SL.

   Also the company has been incurring profits since 20XX. It has decided in 20X0-20X1 to distribute profits to its employees @ 4% during the year. However, due to the employee turnover in the organisation, the expected pay-out of the Cisca Pvt. Ltd. is expected to be around 3.5%. The profits earned during 20X0-20X1 is ₹ 2,000 crores.

Cisca Pvt. Ltd. has a post-employment benefit plan also available which is in the nature of defined contribution plan where contribution to the fund amounts to ₹ 100 crores which will fall due within 12 months from the end of accounting period.

The company has paid ₹ 20 crores to its employees in 20X0-20X1.

What would be the treatment of the short-term compensating absences, profit-sharing plan and the defined contribution plan in the books of Cisca Pvt. Ltd?

6. OPQ Ltd is a listed company having its corporate office at Nagpur. The company has a branch office at Chennai. The company has been operating in Indian market for the last 10 years.

The company operates a pension plan that provides a pension of 2.5% of the final salary for each year of service. The benefits become vested after seven years of service.

On 1st April, 20X8, the company increased the pension to 3% of the final salary for each year of service starting from 1st April, 20X1. On the date of the improvement, the present value of the additional benefits for service from 1st April, 20X1 to 1 April 20X8 was as follows:

- Employees with more than seven years' service on 1 January 20X8 – ₹ 2,75,000
- Employees with less than 7 years of service – ₹ 2,21,000 (average 4 years to go).

What would be the accounting treatment in this case?

7. SA Pvt Ltd is engaged in the business of retail having 100 retail outlets across Northern and Southern India. The company''s head office is located at Chennai.

SA Pvt Ltd is a subsidiary of SAG Ltd. SAG Ltd is listed on the National Stock Exchange in India.

Following information is available for SA Pvt Ltd:

Plan Assets

At 1st April, 20X1, the fair value of plan assets was ₹ 10,000.

Contribution to the plan assets done on 31st March, 20X2 – ₹ 3,000

Amount paid on 31st March, 20X2 – ₹ 300

At 31st March, 20X2, the fair value of plan assets was ₹ 14,700

Actual return on plan assets – ₹ 2,000

Defined Benefit Obligation

At 1st April, 20X1, present value of the defined benefit obligation was ₹ 12,000.

At 31st March, 20X2, present value of the defined benefit obligation was ₹ 15,500.

Actuarial losses on the obligation for the year ended 31st March, 20X2 were ₹ 100.

Current Service Cost – ₹ 2,500

Benefit paid – ₹ 300

Discount rate used to calculate defined benefit liability - 10%.

As per Ind AS 19, please suggest if there is any amount based on the above mentioned information that would be taken to other comprehensive income (with workings). Also compute net interest on the net defined benefit liability (asset).

Answers

1. At 31st March, 20X1, the average unused entitlement is two days per employee. The entity expects, on the basis of experience that is expected to continue, that 92 employees will take no more than five days of paid sick leaves in 20X1-20X2 and that the remaining eight employees will take an average of six and a half days each.

   The entity expects that it will pay an additional twelve days of sick pay as a result of the unused entitlement that has accumulated at 31st March, 20X1 (one and a half days each, for eight employees).

   Therefore, the entity would recognize a liability equal to twelve days of sick pay.

2. Benefit equal to the present value, at the expected retirement date, of a monthly pension of 0.3% of the estimated final salary payable from the expected retirement date until the expected date of death is attributed to each year of service. The current service cost is the present value of that benefit.

   The present value of the defined benefit obligation is the present value of monthly pension payments of 0.3% of final salary, multiplied by the number of years of service up to the end of the reporting period. The current service cost and the present value of the defined benefit obligation are discounted because pension payments begin at the age of 65.

3. No benefit is attributed to service before the age of 25 because service before that date does not lead to benefits (conditional or unconditional). A benefit of ₹ 140 is attributed to each subsequent year.

4. As per Ind AS 19, the benefit will be attributed till the period the employee service will lead to no material amount of benefits. And service in later years will lead to a materially higher level of benefit than in earlier years. Therefore, for employees expected to leave after twenty or more years, the entity would attribute benefit on a straight-line basis. Service beyond twenty years will lead to no material amount of further benefits. Therefore, the benefit attributed to each of the first twenty years is 2.5% (i.e. 50% divided by 20) of the present value of the expected medical costs.

   For employees expected to leave between ten and twenty years, the benefit attributed to each of the first ten years is 2% (20 % divided by 10) of the present value of the expected medical costs. For these employees, no benefit is attributed to service between the end of the tenth year and the estimated date of leaving.

For employees expected to leave within ten years, no benefit is attributed.

5. (i) Cisca Pvt. Ltd. will recognise a liability in its books to the extent of 5 days of PL for 200 employees and 10 days of PL for remaining 800 employees and 2 days of SL for 200 employees and 5 days of SL for remaining 800 employees in its books as an unused entitlement that has accumulated in 20X0-20X1 as short-term compensated absences.

   (ii) Cisca Pvt. Ltd. will recognise ₹ 70 crores (2,000 x 3.5%) as a liability and expense in its books of account.

   (iii) When an employee has rendered service to an entity during a period, the entity shall recognise the contribution payable to a defined contribution plan in exchange for that service.

   Under Ind AS 19, the amount of ₹ 80 crores will be recognised as a liability (accrued expense), after deducting any contribution already paid (100-20) and an expense in the statement of profit and loss. However, if the contribution already paid would have exceeded the contribution due for service before the end of the reporting period, an entity shall recognise that excess as an asset (prepaid expense).

   It can also be seen that the contributions are payable within 12 months from the end of the year in which the employees render the related service, they will not be discounted. However, where contributions to a defined contribution plan do not fall due wholly within twelve months after the end of the period in which the employees render the related service, they shall be discounted using the discount rate.

6. OPQ Ltd increased the pension to 3% of the final salary for each year of service starting from 1st April, 20X1 to 1st April, 20X8.

The company would recognize the total amount of ₹ 4,96,000 (i.e. ₹ 2,75,000 + ₹ 2,21,000) immediately, as for the purpose of recognition it does not make any difference as to whether the benefits are already vested or not.

7. As per Ind AS 19, net remeasurement of ₹ 900 would be recognized in other comprehensive income.

Computation of Net remeasurement

= Remeasurement – Actuarial loss

= ₹ 1000 (Refer WN - 1) – ₹ 100 (Given in the question)

= ₹ 900.

Computation of net interest expense

Particulars	Amount in ₹
Defined benefit liability as at 1 April 20X1 **(A)(Given in the question)**	12,000
Fair value of plan asset as at 1 April 20X1 **(B) (Given in the question)**	(10,000)
Net defined benefit liability **(A - B)**	2,000
Net interest expense (as it is net liability) (Refer note given below)	200

Note:

Net interest expense would be computed on net defined benefit liability using discount rate of 10% given in the question-

= Net defined benefit liability x Discount rate

= 2,000 x 10%

= ₹ 200.

Working Note:

Computation of amount of remeasurement

Particulars	Amount in ₹
Actual return on plan asset for the year ended 31 March 20X2 **(C)** **(Given in the question)**	2,000
Less: Interest income on ₹ 10,000 held for 12 months at 10% **(D)**	(1,000)
Remeasurement **(E = C - D)**	1,000

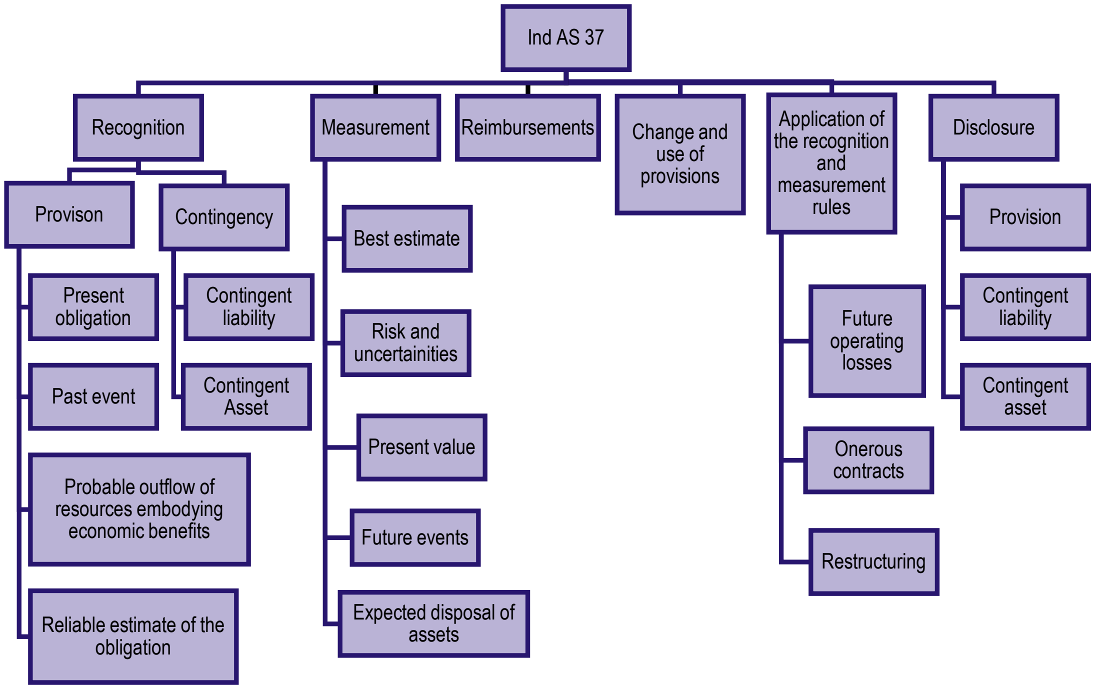
UNIT 2:
INDIAN ACCOUNTING STANDARD 37 : PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Define the terms like ‘provision’, ‘contingent liability’, ‘contingent asset’, obligating event, legal obligation, constructive obligation onerous contracts and restructuring
- Appreciate the relationship between provision and contingent liability
- Recognise provision by examining present and past obligation, probability and estimate of the cash outflow.
- Apply the recognition principles of contingent assets and contingent liabilities
- Apply the recognition and measurement principles for future operating losses, Onerous contracts and restructuring
- Comply with the disclosure requirements with regard to disclosure of contingent liabilities and contingent assets as per Ind AS 37
- Differentiate between Ind AS 37 and AS 29

UNIT OVERVIEW



2.1 OBJECTIVE

The objective of Ind AS 37 is to ensure that

- appropriate recognition criteria and measurement bases are applied to
  - provisions,
  - contingent liabilities and
  - contingent assets and
- sufficient information is disclosed in the notes to enable users to understand their
  - nature,
  - timing and
  - amount.

2.2 SCOPE

Ind AS 37 should be applied by all entities in accounting for provisions, contingent liabilities and contingent assets, **except:**

(a) those resulting from executory contracts, except where the contract is onerous; and

(b) financial instruments (including guarantees) that are within the scope of Ind AS 109, *Financial Instruments;*

(c) those covered by another Standard such as:

 (i) revenue from contracts with customers covered by Ind AS 115. However, Ind AS 115 contains no specific requirement to address onerous contracts with customers. Hence, Ind AS 37 applies to such cases;

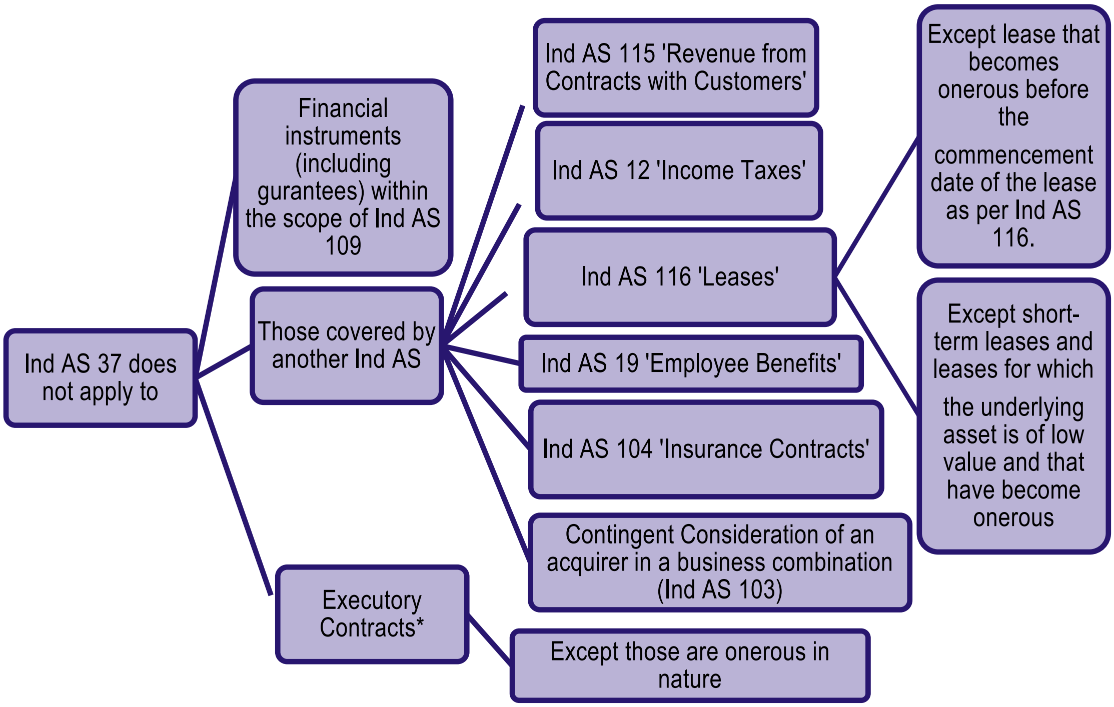
 (ii) income taxes (Ind AS 12, *Income Taxes*);

 (iii) leases (Ind AS 116, *Leases*). However, this Standard applies to any lease that becomes onerous before the commencement date of the lease as defined in Ind AS 116. This Standard also applies to short-term leases and leases for which the underlying asset is of low value accounted for in accordance with paragraph 6 of Ind AS 116 and that have become onerous;

 (iv) employee benefits (Ind AS 19, *Employee Benefits*); and

 (v) insurance contracts (Ind AS 104, *Insurance Contracts*). However, Ind AS 37 applies to provisions, contingent liabilities and contingent assets of an insurer, other than those arising from its contractual obligations and rights under insurance contracts within the scope of Ind AS 104.

 (vi) Contingent consideration of an acquirer in a business combination (Ind AS 103, *Business Combinations*)



2.2.1 Executory Contracts

Executory contracts are contracts under which

- ❖ neither party has performed any of its obligations or
- ❖ both parties have partially performed their obligations to an equal extent.

Note: Ind AS 37 is applied to executory contracts only if they are onerous.

Examples of executory contracts: Take & Pay contracts and through put contracts.

In case of take and pay contracts, an agreement is entered into between two entities wherein the purchaser is legally obligated to take delivery of goods or accept services offered by seller (and make payment for those goods or services) and if the goods or services are not taken, he is required to pay a specified amount of penalty.

In case of through put contracts, an agreement is entered into between two entities wherein one entity undertakes to pass (put through) to another entity an agreed minimum amount of material or services during a specified period of time.

Such types of commitments, the entity has entered into are exempt from the requirements of Ind AS 37, i.e., such contracts are not covered under Ind AS 37 unless they are onerous.

2.2.2 Provisions when relate to the recognition of revenue or expense/losses

❖ Some amounts treated as provisions may relate to the recognition of revenue.

> **Example:** Where an entity gives guarantees in exchange for a fee.

Ind AS 37 does not address the recognition of revenue since there is a separate standard on it i.e. Ind AS 115, *Revenue from Contracts with Customers.* However, Ind AS 115 does not deal with onerous contracts with customers, so Ind AS 37 will deal with the same.

❖ As per Ind AS 37, provisions are liabilities of uncertain timing or amount. However, the term 'provision' is also used for certain adjustments which are made to the carrying amounts of assets.

> **Example :** Depreciation, impairment of assets and doubtful debts.

The provisions which are adjustments to the carrying amounts of assets are not addressed in Ind AS 37 since other Ind AS specifies their treatment. Ind AS 37 neither prohibits nor requires capitalisation of the costs recognised when a provision is made.

❖ Ind AS 37 applies to provisions for restructurings (including discontinued operations). When a restructuring meets the definition of a discontinued operation, additional disclosures may be required by Ind AS 105, *Non-current Assets Held for Sale and Discontinued Operations.*

2.3 DEFINITIONS

The following definitions are relevant for the purpose of understanding the requirements of Ind AS 37.

1. A ***provision*** is a liability of uncertain timing or amount.
2. A ***liability*** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
3. An ***obligating event*** is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

> **Example**
>
> X Ltd. entered into a contract with Y Ltd. for supply of some material. As per the terms of contract in case of breach of contract, the party who breaches the contract has to pay ₹ 50,00,000 to other party. X Ltd. breached the contract with Y Ltd. Now in this case the obligating event is the breach of contract that gave rise to present obligation and X Ltd. must settle the obligation.

4. A ***legal obligation*** is an obligation that derives from:

   (a) a contract (through its explicit or implicit terms);

   (b) legislation; or

   (c) other operation of law.

   In the aforesaid example regarding breach of the contract, the obligation is a legal obligation that arises from the terms of contract.

5. A ***constructive obligation*** is an obligation that derives from an entity's actions where:

   (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

   (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

   Example

   X Ltd. is engaged in the manufacture of fertilisers. Effluents discharged in the manufacturing process have polluted the river near the manufacturing plant. The residents of the nearby locality launched a massive agitation against the pollution. X Ltd. agreed to their demands to reduce the water pollution by installing the necessary Effluent Treatment Plant. However, during the year no steps are taken to install the plant. No legislation requiring the company to reduce its pollution is in existence. In this case, though there is no law but by promising to take steps to reduce pollution, X Ltd. has created a valid expectation on the part of public that it will discharge its responsibilities. So the obligation in this case is a constructive obligation.

6. A contingent liability is:

   (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

   (b) a present obligation that arises from past events but is not recognised because:

      (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

      (ii) the amount of the obligation cannot be measured with sufficient reliability.

Example

A tax case pending before the court, the liability for payment arising or not in respect of which depends on the outcome of court decision is a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

7. A ***contingent asset*** is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

Example

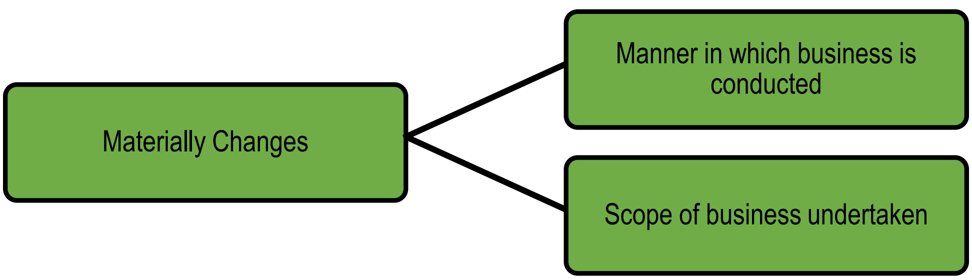
X Ltd. filed a legal suit against a supplier of goods for compensation against damages on non–supply of contracted goods. This meets the definition of a contingent asset since there is a possible asset (compensation against damages) that arose from past event (contract with the supplier) and whose existence will be confirmed by the occurrence or non-occurrence of uncertain future event not wholly within the control of the entity (i.e., the outcome of the legal suit).

8. An ***onerous contract*** is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

9. A ***restructuring*** is a programme that is planned and controlled by management, and materially changes either:

   (a) the scope of a business undertaken by an entity; or

   (b) the manner in which that business is conducted.



2.4 PROVISIONS AND OTHER LIABILITIES

Since there is uncertainty about the timing or amount of the future expenditure required in settlement of the provisions, they are different from liabilities. However, in case of liability, uncertainty is generally much less than for provisions. By contrast:

(a) trade payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier; and

(b) accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees.

Example: Amounts relating to accrued vacation pay.

Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions.

Note: Accruals are often reported as part of trade and other payables, whereas provisions are reported separately.

2.5 RELATIONSHIP BETWEEN PROVISIONS AND CONTINGENT LIABILITIES

In a general sense, all provisions are contingent because they are uncertain in timing or amount. However, Ind AS 37 distinguishes between the term 'contingent' and 'provisions'.

(a) **Provisions –** which **are recognised as liabilities** (assuming that a reliable estimate can be made) because they are present obligations and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations; and

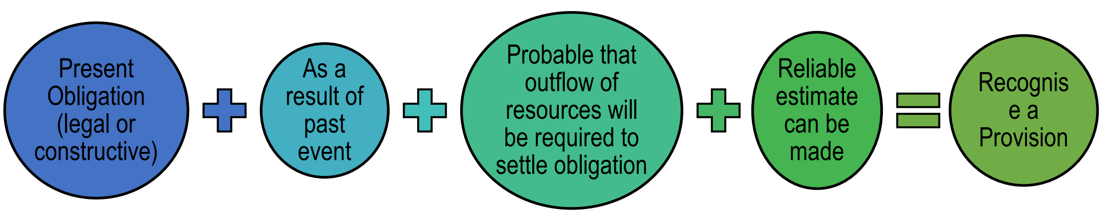
(b) **Contingent Liabilities –** which **are not recognised as liabilities** because they are either:

   (i) possible obligations, as it has yet to be confirmed whether the entity has a present obligation that could lead to an outflow of resources embodying economic benefits; or

   (ii) present obligations that do not meet the recognition criteria in Ind AS 37 (because either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a sufficiently reliable estimate of the amount of the obligation cannot be made).

2.6 RECOGNITION

2.6.1 Provisions



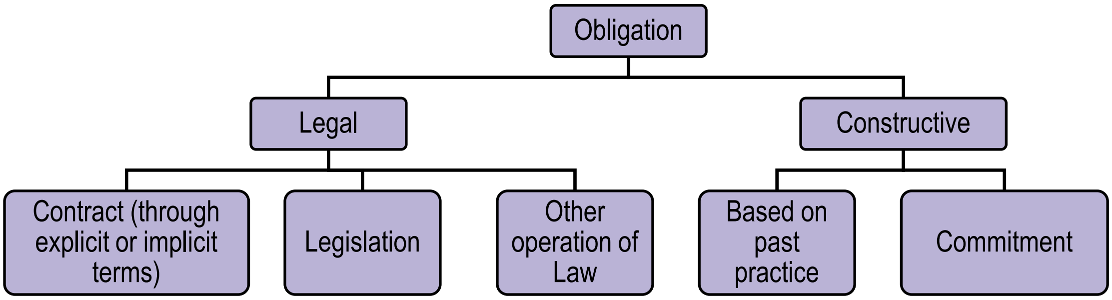
A provision should be recognised when:

(a) an entity has a **present obligation** (legal or constructive) as a result of a **past event**;

(b) it is **probable that an outflow of resources embodying economic benefits** will be required to settle the obligation; and

(c) a **reliable estimate** can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.



2.6.1.1 Present Obligation

- ❖ In general, it is clear that there is a present obligation. Only, in rare cases it is not clear whether there is a present obligation.
- ❖ In almost all cases it will be clear whether a past event has given rise to a present obligation.

  In rare cases, for example in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation.

- ❖ Where it is not clear whether there is a present obligation, past event shall be evaluated.
- ❖ In such a case, an entity should take into account all available evidence, including the opinion of experts. The evidence considered includes any additional evidence provided by events after the reporting period.
- ❖ On the basis of such evidence:

  (a) where it is **probable (i.e. more likely than not) that a present obligation exists** at the end of the reporting period,

  ✓ the entity **recognises a provision** (if the recognition criteria are met); and

  (b) where it is **more likely that no present obligation exists** at the end of the reporting period,

  ✓ the entity discloses a contingent liability, if the possibility of an outflow of resources embodying economic benefits is not remote.

  Note: It may be inferred that if the possibility of an outflow of resources embodying economic benefits is remote, then the entity need not disclose the contingent liability.

2.6.1.2 Past Event

- ❖ A past event that leads to a present obligation is called an obligating event. Obligating event, is the event where the entity has no realistic alternative to settling the obligation created by the event. This is the case only:

(a) where the settlement of the obligation can be enforced by law; or

(b) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation.

❖ There should be a past event which lead to present obligation and give rise to a liability for which a provision is required to be made.

Example

1. In respect of warranty provision, it would be the original sale.
2. In respect of contamination of land, it would be the original contamination.
3. In respect of Provision for dismantling or cleaning the oil rig, it would be when the oil rig is first built.

❖ No provision is recognised for costs that need to be incurred by an entity to operate in the future.

❖ The only liabilities recognised in an entity's balance sheet are those that exist at the end of the reporting period.

❖ It is only those obligations arising from past events existing independently of an entity's future actions (i.e., the future conduct of its business) that should be recognised as provisions.

Example

1. Penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the entity.
2. Similarly, an entity should recognise a provision for the decommissioning costs of an oil installation or a nuclear power station to the extent that the entity is obliged to rectify damage already caused.

❖ In contrast, because of commercial pressures or legal requirements, an entity may intend or need to carry out expenditure to operate in a particular way in the future

❖ The entity can avoid the future expenditure by its future actions (for example by changing its method of operation). In such a case, it has no present obligation for that future expenditure and no provision is recognised.

Example: Fitting smoke filters in a certain type of factory.

Since, the entity can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

Example: Staff retraining as a result of changes in the income tax system

The government introduces a number of changes to the income tax system. As a result of these changes, an entity in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the end of the reporting period, no retraining of staff has taken place. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – There is no obligation because no obligating event (retraining) has taken place.

Conclusion – No provision is recognised.

Example: Legal requirement to fit smoke filters

Under new legislation, an entity is required to fit smoke filters to its factories by September 30, 20X1. The entity has not fitted the smoke filters. It is assumed that a reliable estimate can be made of any outflows expected.

(a) At March 31, 20X1, the end of the reporting period

Present obligation as a result of a past obligating event – There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.

Conclusion – No provision is recognised for the cost of fitting the smoke filters.

(b) At March 31, 20X2, the end of the reporting period

Present obligation as a result of a past obligating event – There is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

An outflow of resources embodying economic benefits in settlement – Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

Conclusion – No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed.

Example: Repairs and maintenance

Some assets require, in addition to routine maintenance, substantial expenditure every few years for major refits or refurbishment and the replacement of major components. Ind AS 16, *Property, Plant and Equipment* gives guidance on allocating expenditure on an asset to its component parts where these components have different useful lives or provide benefits in a different pattern.

Example: Refurbishment costs – no legislative requirement

A furnace has a lining that needs to be replaced every five years for technical reasons. At the end of the reporting period, the lining has been in use for three years. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – There is no present obligation.

Conclusion – No provision is recognised.

The cost of replacing the lining is not recognised because, at the end of the reporting period, no obligation to replace the lining exists independently of the company's future actions—even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining. Instead of a provision being recognised, the depreciation of the lining takes account of its consumption, i.e., it is depreciated over five years. The re-lining costs then incurred are capitalised with the consumption of each new lining shown by depreciation over the subsequent five years.

Example: Refurbishment costs – legislative requirement

An airline is required by law to overhaul its aircraft once every three years. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – There is no present obligation.

Conclusion – No provision is recognised.

The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision in above Example on refurbishment costs. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the entity's future actions—the entity could avoid the future expenditure by its future actions, for example by selling the aircraft. Instead of a provision being recognised, the depreciation of the aircraft takes account of the future incidence of maintenance costs, i.e., an amount equivalent to the expected maintenance costs is depreciated over three years.

Illustration 1

X Shipping Ltd. is required by law to overhaul its shipping fleet once in every 3 years. The company's finance team was of the view that recognising the costs only when paid would prevent matching of revenue earned all the time with certain costs of large amounts which are incurred occasional. Thereby, it has formulated an accounting policy of providing in its books of account for the future cost of maintenance (overhauls, annual inspection etc.) by calculating a rate per hours sailed on sea and accumulating a provision over time. The provision is adjusted when the expenditure is actually incurred. Is the accounting policy of X Shipping Ltd. correct?

Solution

A provision is made for a present obligation arising out of a past event. Overhauling does not arise out of past event. Even a legal requirement to overhaul does not make the cost of overhaul a liability, because no obligation exists to overhaul the ships independently of the company's future actions - the company could avoid the future expenditure by its future actions for example by selling the ships. So there is no present obligation.

As per the standard, financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an entity's balance sheet are those that exist at the end of the reporting period.

Therefore, the accounting policy of X Shipping Ltd. is not correct. The company should adopt the component approach in Ind AS 16, *Property, Plant and Equipment*, for accounting for the refurbishment cost.

*****

- An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed.
- A management or board decision does not give rise to a constructive obligation at the end of the reporting period unless the decision has been communicated before the end of the reporting period to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will discharge its responsibilities.
- An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law or because an act (for example, a sufficiently specific public statement) by the entity gives rise to a constructive obligation.

Example

An entity may not be obliged to remedy the consequences due to causing of environmental damage by it. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified or when the entity publicly accepts responsibility for rectification in a way that creates a constructive obligation.

- Where details of a proposed new law have yet to be finalised, an obligation would arise only when the legislation is virtually certain to be enacted as drafted. For the purpose of Ind AS 37, such an obligation is treated as a legal obligation. Differences in circumstances surrounding enactment make it impossible to specify a single event that would make the enactment of a law virtually certain. In many cases it will be impossible to be virtually certain of the enactment of a law until it is enacted.

Example: Contaminated land – legislation virtually certain to be enacted

An entity in the oil industry (having 31 March year-end) causes contamination but cleans up only when required to do so under the laws of the particular country in which it operates. One country in which it operates has had no legislation requiring cleaning up, and the entity has been contaminating land in that country for several years. At March 31, 20X1, it is virtually certain that a draft law requiring a clean-up of land already contaminated will be enacted shortly after the year-end. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.

An outflow of resources embodying economic benefits in settlement – Probable.

Conclusion – A provision is recognised for the best estimate of the costs of the clean-up.

Example: Contaminated land and constructive obligation

An entity in the oil industry (having 31 March year-end) causes contamination and operates in a country where there is no environmental legislation. However, the entity has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. The entity has a record of honouring this published policy. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event- The obligating event is the contamination of the land, which gives rise to a constructive obligation because the conduct of the entity has created a valid expectation on the part of those affected by it that the entity will clean up contamination.

An outflow of resources embodying economic benefits in settlement- Probable.

Conclusion- A provision is recognised for the best estimate of the costs of clean-up.

Example: Offshore oilfield

An entity operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. 90% of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and 10% arise through the extraction of oil. At the end of the reporting period, the rig has been constructed but no oil has been extracted. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The construction of the oil rig creates a legal obligation under the terms of the license to remove the rig and restore the seabed and is thus an obligating event. At the end of the reporting period, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

An outflow of resources embodying economic benefits in settlement – Probable.

Conclusion – A provision is recognised for the best estimate of ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it. These costs are included as part of the cost of the oil rig. The 10% of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted.

Example: A Court case

After a wedding in 20X1-20X2, ten people died, possibly as a result of food poisoning from products sold by the entity. Legal proceedings are started seeking damages from the entity but it disputes liability. Up to the date of approval of the financial statements for the year to 31 March 20X2 for issue, the entity's lawyers advise that it is probable that the entity will not be found liable. However, when the entity prepares the financial statements for the year to 31 March 20X3, its lawyers advise that, owing to developments in the case, it is probable that the entity will be found liable. It is assumed that a reliable estimate can be made of any outflows expected.

(a) At 31 March 20X2

Present obligation as a result of a past obligating event – On the basis of the evidence available when the financial statements were approved, there is no obligation as a result of past events.

Conclusion – No provision is recognised. The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

(b) At 31 March 20X3

Present obligation as a result of a past obligating event – On the basis of the evidence available, there is a present obligation.

An outflow of resources embodying economic benefits in settlement – Probable.

Conclusion – A provision is recognised for the best estimate of the amount to settle the obligation.

Illustration 2

X Chemical Ltd. is operating in the vicinity of a river since 20 years. A community living near X Chemical Ltd. claims that its operations has caused contamination of drinking water. X Chemical Ltd. has received notice from the governmental environmental agency that official investigations will be made into claims of pollution caused by the entity. If it is found that X Chemical Ltd. has caused contamination, then penalties and fine would be levied on it.

X Chemical Ltd. believes that it has implemented all environmental safety measures to an extent that it is unlikely to cause pollution. Management is not sure whether it has all the information about the entire 20 years. Therefore, neither management nor external experts are able to assess X Chemical Ltd.'s responsibility until the investigation has completed.

In such situation, how should management of X Chemical Ltd. account for a liability?

Solution

As per the standard, in the present case, the available evidence does not support a conclusion that a present obligation exists. However, there is a possible obligation which exists and will be confirmed upon completion of investigations. Therefore, management should disclose the contingent liability for potential penalties and fines that may be imposed if contamination is proved.

*****

2.6.1.3 Probable Outflow of Resources Embodying Economic Benefits

- For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation.

> **Note:** For the purpose of Ind AS 37[1], an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not.

- Where it is not probable that a present obligation exists, an entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

- Where there are a number of similar obligations (e.g., product warranties or similar contracts) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision should be recognised (if the other recognition criteria are met).

Example: Warranties

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (i.e., more likely than not) that there will be some claims under the warranties. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The obligating event is the sale of the product with a warranty, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement – Probable for the warranties as a whole.

Conclusion – A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the end of the reporting period.

[1] The interpretation of 'probable' in Ind AS 37 as 'more likely than not' does not necessarily apply in other Ind AS.

Example: Refunds policy

A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The obligating event is the sale of the product, which gives rise to a constructive obligation because the conduct of the store has created a valid expectation on the part of its customers that the store will refund purchases.

An outflow of resources embodying economic benefits in settlement – Probable, a proportion of goods are returned for refund.

Conclusion – A provision is recognised for the best estimate of the costs of refunds.

2.6.1.4 Reliable Estimate of the Obligation

- The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than most other items in the balance sheet.
- Except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision.

Illustration 3

X Ltd. has entered into an agreement with its selling agent Y, in accordance with which X Ltd. has to pay a base percentage of commission on export sales and an additional commission is to be paid if the export incentives are received. As per the accounting policy of X Ltd., it recognises export incentives when actually realised, on account of the uncertainty in realising such incentives. Export incentives have not been received for the year 20X1-20X2, however X Ltd. is hopeful of receiving the export incentives in the year 20X2-20X3. In the financial statements for 20X1-20X2, should X Ltd. provide for both base commission and additional commission?

Solution

So far as the base percentage of sales commission is concerned, it is a present obligation arising out of past events. The obligating event takes place when the sales are made and also since commission is based on percentage of sale, reliable estimation can also be made. Therefore, the base percentage of sales commission should be provided.

However, in respect of additional commission, it is to be paid when the export incentives are recognised and export incentives are recognised only when it is received. Therefore, the obligating event will arise only when export incentives are received. Hence, no provision for additional commission is to be made in financial year 20X1-20X2. The expectation of X Ltd. to receive the export incentives in next year would not make any difference as on 31 March 20X2.

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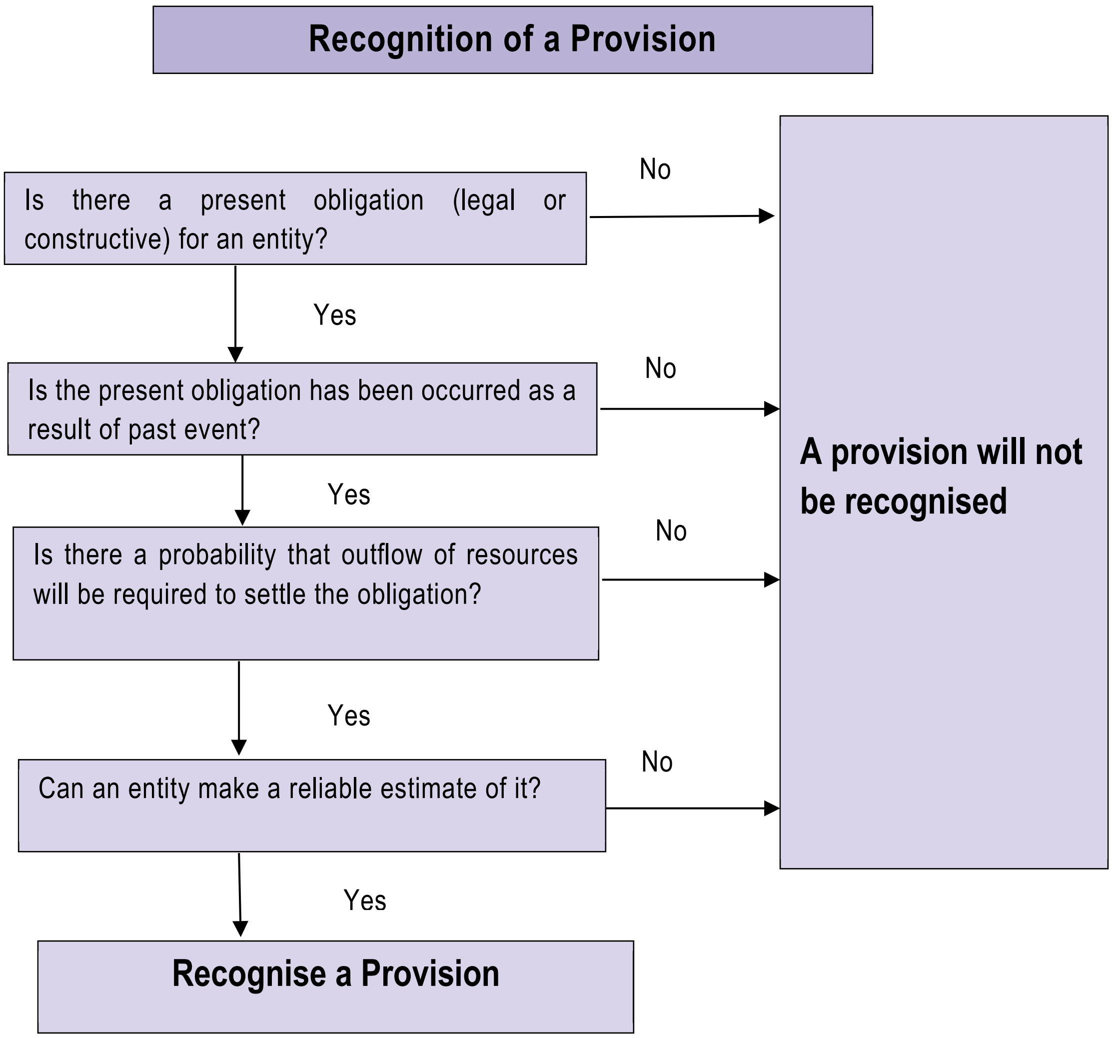
- ❖ In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a contingent liability.



2.6.2 Contingent Liabilities

- ❖ An entity should not recognise a contingent liability.
- ❖ A contingent liability should be disclosed, if the possibility of an outflow of resources embodying economic benefits is not remote.
- ❖ Where an entity is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties should be treated as a contingent liability.

- The entity should recognise a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made.
- Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable.
- If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision should be recognised in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made).

The principles describing provisions and contingent liabilities is as follows:

Where, as a result of past events, there may be an outflow of resources embodying future economic benefits in settlement of: (a) a present obligation; or (b) a possible obligation whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.		
There is a present obligation that probably requires an outflow of resources.	**There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.**	**There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.**
A provision is recognised.	No provision is recognised.	No provision is recognised.
Disclosures are required for the provision.	Disclosures are required for the contingent liability.	No disclosure is required.

A contingent liability also arises in the extremely rare case where there is a liability that cannot be recognised because it cannot be measured reliably. Disclosures are required for the contingent liability.

2.6.3 Contingent Assets

- An entity should not recognise a contingent asset.
- Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the entity.

Example

A claim that an entity is pursuing through legal processes, where the outcome is uncertain.

- Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised.

- However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.
- A contingent asset should be disclosed, where an inflow of economic benefits is probable.
- Contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements **of the period in which the change occurs.**

Where, as a result of past events, there is a possible asset whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity		
The inflow of economic benefits is virtually certain	**The inflow of economic benefits is probable, but not virtually certain**	**The inflow is not probable**
The asset is not contingent and its recognition is appropriate	No asset is recognised	No asset is recognised
	Disclosures are required	No disclosure is required

Tabular depiction

Likelihood of outcome	Contingent liability	Contingent asset
Virtually certain (greater than 95% probability)	Recognise the provision	Recognise the asset
Probable (50% - 95% of probability)	Recognise the provision	Disclose about the contingent asset
Possible but not probable (5% - 50% of probability)	Disclose the contingency	No disclosure permitted
Remote (less than 5% probability)	No disclosure required	No disclosure permitted

Illustration 4

X Sugars Ltd. has entered into a sale contract of ₹ 3,00,00,000 with Y Choclates Ltd. for the supply of sugar during 20X1-20X2. As per the contract the delivery is to be made within 2 months from the date of contract. In case of failure to deliver within the schedule, X Sugars Ltd. has to pay a compensation of ₹ 30,00,000 to Y Chocolates Ltd.

During the transit, the vehicle carrying the sugar met accident and X Sugar Ltd. lost the entire consignment. It is, however covered by an insurance policy. According to the report of the *surveyor, the amount is collectible, subject to the deductible clause [i.e., 15% of the claim] in the insurance policy. The cost of goods lost was ₹ 2,50,00,000.*

Before the financial year end, X Sugars Ltd. received informal information from the insurance company that their claim had been processed and the payment had been dispatched for 85% of the claim amount. Meanwhile Y Chocolates Ltd. has made demand of ₹ 30,00,000 since the goods were not delivered on time.

What provision or disclosure would X Ltd. need to make at year end?

Solution

As per the standard, where an inflow of economic benefits is probable, an entity should disclose a brief description of the nature of the contingent assets at the end of the reporting period, and, where practicable, an estimate of their financial effect, measured using the principles set out in Ind AS 37.

So X Sugars Ltd. would need to disclose the contingent asset of ₹ 2,12,50,000 (₹ 2,50,00,000 x 85%) at the end of the financial year 20X1-20X2.

It would also need to make a provision of ₹ 30,00,000 towards the claim of Y Chocolates Ltd.

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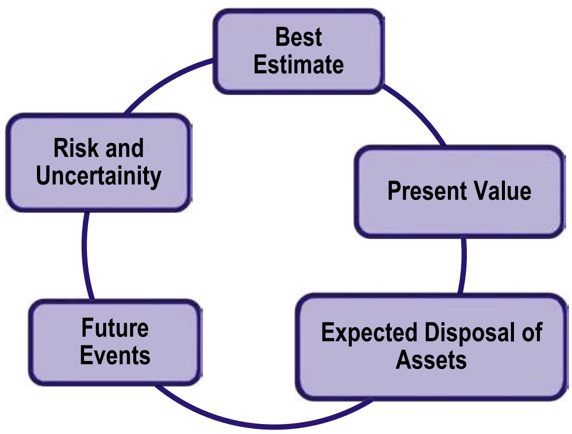
2.7 MEASUREMENT



2.7.1 Best Estimate

- ❖ The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.
- ❖ The estimate of the amount that an entity would rationally pay to settle or transfer the obligation gives the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

- The estimates of outcome and financial effect are determined by the judgement of the management of the entity, supplemented by experience of similar transactions and in some cases, reports from independent experts, for example, in legal cases, expert legal advice might be taken. The evidence considered includes any additional evidence provided by events after the reporting period.
- Uncertainties surrounding the amount to be recognised as a provision are dealt with by various means according to the circumstances. Where the provision being measured involves a large population of items, for example, customer refunds, warranties, etc., the obligation is estimated by weighting all possible outcomes by their associated probabilities. The name for this statistical method of estimation is 'expected value'. The provision will therefore be different depending on whether the probability of a loss of a given amount is, for example, 60% or 90%.
- Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used.

Illustration 5

An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent within the first six months after purchase. If minor defects were detected in all products sold, repair costs of ₹ 1 million would result. If major defects were detected in all products sold, repair costs of ₹ 4 million would result. The entity's past experience and future expectations indicate that, for the coming year, 75% of the goods sold will have no defects, 20% of the goods sold will have minor defects and 5% of the goods sold will have major defects. In accordance with the standard, an entity assesses the probability of an outflow for the warranty obligations as a whole.

Solution

The expected value of the cost of repairs is:

(75% of nil) + (20% of 1m) + (5% of 4m) = ₹ 4,00,000

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- Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. However, even in such a case, the entity considers other possible outcomes.
- Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount.

Examples

1. If an entity has an environmental obligation to clean up the drinking water that got contaminated, there might be a number of different ways to carry out this work. Each of these methods would have different probabilities of success and would cost different amounts. In such case, the entity might choose the method which has the most likely possibility of success.

2. If an entity has to rectify a serious fault in a major plant that it has constructed for a customer, the individual most likely outcome may be for the repair to succeed at the first attempt at a cost of ₹ 1,000, but a provision for a larger amount is made if there is a significant chance that further attempts will be necessary.

❖ The provision should be measured before tax, as the tax consequences of the provision, and changes in it, are dealt with under Ind AS 12.

2.7.2 Risks and Uncertainties

❖ The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

❖ Risk describes variability of outcome.

❖ A risk adjustment should be made for the amount that the entity would pay in excess of the expected present value of outflows due to uncertainty attached with the actual outcome.

❖ A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgements under conditions of uncertainty, so that income or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities.

  For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case.

❖ Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.

❖ Risk adjustment can be accounted for in number of ways such as:

  - Adding it to the expected present value of future outflows.
  - Adjusting the estimates of future outflows.
  - Adjusting the discount rate.

❖ Disclosure of the uncertainties surrounding the amount of the expenditure should be made.

2.7.3 Present Value

❖ Where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditures expected to be required to settle the obligation.

❖ Because of the time value of money, provisions relating to cash outflows that arise soon after the reporting period are more onerous than those where cash outflows of the same amount arise later. Provisions should therefore be discounted, where the effect is material.

❖ Ind AS 37 does not require cash flows to be discounted unless this has a material effect.

❖ The expected present value of outflows are calculated as follows:
  - Each outcome is discounted to its present value.
  - The present value of outcomes are weighted by their associated probabilities.

❖ **The discount rate (or rates) should be a pre-tax rate (or rates)** that reflect(s) current market assessments of the time value of money and the risks specific to the liability.

❖ The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted.

Illustration 6

X Solar Power Ltd., a power company, has a present obligation to dismantle its plant after 35 years of useful life. X Solar Power Ltd. cannot cancel this obligation or transfer to third party. X Solar Power Ltd. has estimated the total cost of dismantling at ₹ 50,00,000, the present value of which is ₹ 30,00,000. Based on the facts and circumstances, X Solar Power Ltd. considers the risk factor of 5% i.e., the risk that the actual outflows would be more from the expected present value. How should X Solar Power Ltd. account for the obligation?

Solution

The obligation should be measured at the present value of outflows i.e., ₹ 30,00,000. Further a risk adjustment of 5% i.e., ₹ 1,50,000 (₹ 30,00,000 x 5%) would be made.

So, the liability will be recognised at = ₹ 30,00,000 + ₹1,50,000 = ₹ 31,50,000.

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2.7.4 Future Events

❖ Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

❖ Expected future events may be particularly important in measuring provisions.

For example, an entity may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology.

The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus, it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an entity does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence. It is fine to anticipate the use of existing method with the some refinement, adaptation and cost reduction, if there is sufficient evidence that such factors are likely to arise in future. However, it would not be acceptable to assume that there would be a completely new idea or a new method, which would cost significantly less.

- The effect of possible new legislation should be taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted. The variety of circumstances that arise in practice makes it impossible to specify a single event that will provide sufficient, objective evidence in every case. Evidence is required both of what legislation will demand and of whether it is virtually certain to be enacted and implemented in due course. In many cases sufficient objective evidence will not exist until the new legislation is enacted.

Illustration 7

X Chemicals Ltd. engaged in the chemical industry causes environmental damage by dumping waste in the river near its factory. It does not clean up because there is no environmental legislation requiring cleaning up and X Chemicals Ltd. is causing damage for last 40 years. As at March 31, 20X2, the State Legislature has passed a path breaking legislation requiring all polluting factories to clean-up the river water already contaminated. The formal Gazette notification of the law is pending. How should X Chemicals Ltd. deal with this situation?

Solution

The obligating event is the contamination of water and because of the virtually certainty of legislation requiring cleaning up, an outflow of resources is certain. It is possible to arrive at best estimated cost for the cleanup activity. So, a provision should be recognised in the books of X Chemicals Ltd. for 20X1-20X2.

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2.7.5 Expected Disposal of Assets

- Gains from the expected disposal of assets should not be taken into account in measuring a provision.
- Gains on the expected disposal of assets should not be taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision.
- Instead, an entity should recognise gains on expected disposals of assets at the time specified by the Standard dealing with the assets concerned.

2.8 REIMBURSEMENTS

- Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.

- In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.
- Sometimes, an entity is able to look to another party to pay part or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses or suppliers' warranties). The other party may either reimburse amounts paid by the entity or pay the amounts directly.
- In most cases the entity will remain liable for the whole of the amount in question so that the entity would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision should be recognised for the full amount of the liability, and a separate asset for the expected reimbursement should be recognised when it is virtually certain that reimbursement will be received if the entity settles the liability.
- In some cases, the entity will not be liable for the costs in question if the third party fails to pay. In such a case the entity has no liability for those costs and they should not be included in the provision.
- As noted earlier, an obligation for which an entity is jointly and severally liable is a contingent liability to the extent that it is expected that the obligation will be settled by the other parties.

In various situations where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the treatment would be as follows:

Reimbursements			
Situation	**The entity has no obligation for the part of the expenditure to be reimbursed by the other party**	**Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party and it is virtually certain that reimbursement will be received if the entity settles the provision**	**Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party but the reimbursement is NOT virtually certain**
Recognition	The entity has no liability for the amount to be reimbursed. Hence no provision will be made.	• The reimbursement is recognised as a separate asset in the balance sheet • In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement. • The amount recognised for the expected reimbursement shall not exceed the liability.	The expected reimbursement is not recognised as an asset.
Disclosure	No disclosure is required.	The reimbursement is disclosed together with the amount recognised for the reimbursement.	The expected reimbursement is disclosed.

Illustration 8

X Beauty Solutions Ltd. is selling cosmetic products under its brand name 'B', but it is getting its product manufactured from Y Ltd. It has an understanding (enforceable agreement) with Y Ltd. that if the company becomes liable for any damage claims, due to any injury or harm to the customer of the cosmetic products, 30% will be reimbursed to it by Y Ltd. During the financial year 20X1-20X2, a claim of ₹ 30,00,000 becomes payable to customers by X Beauty Solutions Ltd. How should X Beauty Solutions Ltd. account for the claim that becomes payable?

Solution

Since the understanding results in an enforceable agreement, the reimbursement of ₹ 9,00,000 (₹ 30,00,000 x 30%) shall be recognised as a reimbursement right and provision will be recognised for ₹ 30,00,000. The reimbursement right shall be treated as a separate asset and shall not be offset with the provision. In the statement of profit and loss, the expense may be presented as ₹ 21,00,000 after offsetting the reimbursement right.

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2.9 CHANGES IN PROVISIONS

- Provisions should be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.
- Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognised as borrowing cost.

Illustration 9

X Telecom Ltd. has income tax litigation pending before appellate authorities. Legal advisor's opinion is that X Telecom Ltd. will lose the case and estimated that liability of ₹ 1,00,00,000 may arise in two years. The liability is recognised on a discounted basis. The discount rate at which the liability has been discounted is 10% and it is assumed that discount rate does not change over the period of 2 years. How should X Telecom Ltd. calculate the amount of borrowing cost?

Solution

The discount factor of 10% for 2 years is 0.827. X Telecom Ltd. will initially recognise provision for ₹ 82,70,000 (₹ 1,00,00,000 x 0.827).

The discount factor of 10% at the end of year 1 is 0.909. At the end of year 1, provision amount would be ₹ 90,90,000 (₹ 1,00,00,000 x 0.909).

As per the standard, the difference between the two present values i.e., ₹ 8,20,000 is recognised as a borrowing cost in year 1.

At the end of the Year 2, the liability would be ₹ 1,00,00,000.

The difference between the two present values i.e., ₹ 9,10,000 (₹ 1,00,00,000 - ₹ 90,90,000) is recognised as borrowing cost in year 2.

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2.10 USE OF PROVISIONS

❖ A provision should be used only for expenditures for which the provision was originally recognised.

❖ Only expenditures that relate to the original provision are set against it. Setting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

2.11 APPLICATION OF THE RECOGNITION AND MEASUREMENT RULES

2.11.1 Future Operating Losses

❖ Provisions should not be recognised for future operating losses.

❖ Future operating losses do not meet the definition of a liability and the general recognition criteria set out for provisions as specified in the standard. Ind AS 37 does not permit recognition of provision for future operating losses this since they do not stem from a past event.

❖ An expectation of future operating losses is an indication that certain assets of the operation may be impaired. An entity should test these assets for impairment under Ind AS 36, *Impairment of Assets.*

Illustration 10

X Packaging Ltd. has two segments, packaging division and paper division. In March 20X1, the board of directors approved and announced a formal plan to sell the paper division in June 20X1. Operating losses of the paper division are estimated to be approximately ₹ 50,00,000 during the period from April 1, 20X1 to the expected date of disposal. Management of X Packaging Ltd. wants to include the future operating loss of ₹ 50,00,000 in a provision for restructuring in the financial statements for the period ended March 31, 20X1. Can X Packaging Ltd. include these operating losses in a provision for restructuring?

Solution

Standard states that provision should not be made for future operating losses. Since Ind AS 37 prohibits the recognition of future operating losses, so X Packaging Ltd. should not include these future operating losses in a provision for restructuring even though these losses relate to the disposal group.

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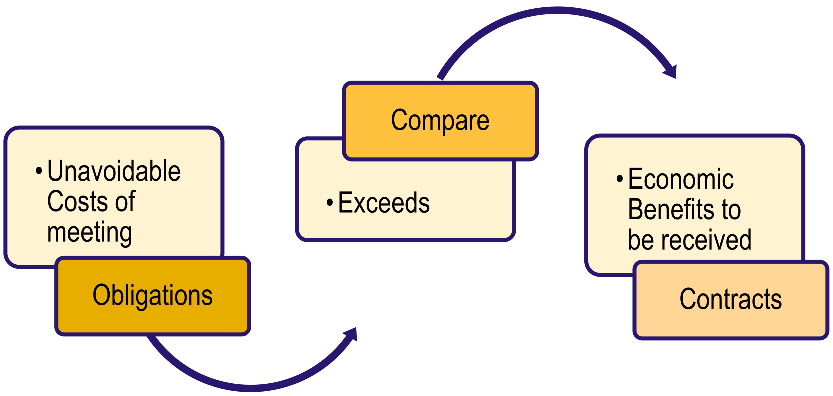
2.11.2 Onerous contracts

❖ If an entity has a contract that is onerous, the present obligation under the contract should be recognised and measured as a provision.



❖ Many contracts (for example, some routine purchase orders) can be cancelled without paying compensation to the other party, and therefore there is no obligation. Other contracts establish both rights and obligations for each of the contracting parties. Where events make such a contract onerous, the contract falls within the scope of Ind AS 37 and a liability exists which is recognised. Executory contracts that are not onerous fall outside the scope of Ind AS 37.

❖ Ind AS 37 defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it.

❖ Before a separate provision for an onerous contract is established, an entity should recognise any impairment loss that has occurred on assets dedicated to that contract (in accordance with Ind AS 36).

Illustration 11

X Metals Ltd. had entered into a non-cancellable contract with Y Ltd. to purchase 10,000 units of raw material at ₹ 50 per unit at a contract price of ₹ 5,00,000. As per the terms of contract, X Metals Ltd. would have to pay ₹ 60,000 to exit the said contract. X Metals Ltd.

has discontinued manufacturing the product that would use the said raw material. For that X Metals Ltd. has identified a third party to whom it can sell the said raw material at ₹ 45 per unit.

How should X Metals Ltd. account for this transaction in its books of account in respect of the above contract?

Solution

These circumstances do indicate an onerous contract. The only benefit to be derived from the purchase contract costing ₹ 5,00,000 are the proceeds from the sale contact, which are ₹ 4,50,000. Therefore, a provision should be made for the onerous element of ₹ 50,000, being the lower of cost of fulfilling the contract and the penal cost of cancellation of ₹ 60,000.

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2.11.3 Restructuring

❖ The following are examples of events that may fall under the definition of restructuring:

(a) sale or termination of a line of business;

(b) the closure of business locations in a country or region or the relocation of business activities from one country or region to another;

(c) changes in management structure, for example, eliminating a layer of management; and

(d) fundamental reorganisations that have a material effect on the nature and focus of the entity's operations.

❖ A provision for restructuring costs should be recognised only when the general recognition criteria for provisions set out the standard are met.

❖ A constructive obligation to restructure arises only when an entity:

(a) has a detailed formal plan for the restructuring identifying at least:

(i) the business or part of a business concerned;

(ii) the principal locations affected;

(iii) the location, function, and approximate number of employees who will be compensated for terminating their services;

(iv) the expenditures that will be undertaken; and

(v) when the plan will be implemented; and

(b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

Example: Closure of a division – no implementation before end of the reporting period

On March 12, 20X1 the board of an entity decided to close down a division. Before the end of the reporting period (March 31, 20X1) the decision was not communicated to any of those affected and no other steps were taken to implement the decision. it is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – There has been no obligating event and so there is no obligation.

Conclusion – No provision is recognised.

Example: Closure of a division – communication/ implementation before end of the reporting period

On March 12, 20X1 (reporting date), the board of an entity decided to close down a division making a particular product. On March 20, 20X1 a detailed plan for closing down the division was agreed by the board; letters were sent to customers warning them to seek an alternative source of supply and redundancy notices were sent to the staff of the division. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The obligating event is the communication of the decision to the customers and employees, which gives rise to a constructive obligation from that date, because it creates a valid expectation that the division will be closed.

An outflow of resources embodying economic benefits in settlement – Probable.

Conclusion – A provision is recognised at March 31, *20X1* for the best estimate of the costs of closing the division.

- Evidence that an entity has started to implement a restructuring plan would be provided, for example, by dismantling plant or selling assets or by the public announcement of the main features of the plan. A public announcement of a detailed plan to restructure constitutes a constructive obligation to restructure only if it is made in such a way and in sufficient detail (i.e., setting out the main features of the plan) that it gives rise to valid expectations in other parties such as customers, suppliers and employees (or their representatives) that the entity will carry out the restructuring.

- For a plan to be sufficient to give rise to a constructive obligation when communicated to those affected by it, its implementation needs to be planned to begin as soon as possible and to be completed in a timeframe that makes significant changes to the plan unlikely. If it is expected that there will be a long delay before the restructuring begins or that the restructuring will take an unreasonably long time, it is unlikely that the plan will raise a valid expectation on the part of others that the entity is at present committed to restructuring, because the timeframe allows opportunities for the entity to change its plans.

- A management or board decision to restructure taken before the end of the reporting period does not give rise to a constructive obligation at the end of the reporting period unless the entity has, before the end of the reporting period:

  (a) started to implement the restructuring plan; or

(b) announced the main features of the restructuring plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will carry out the restructuring.

If an entity starts to implement a restructuring plan, or announces its main features to those affected, only after the reporting period, disclosure is required under, Ind AS 10, *Events after the Reporting Period*, if the restructuring is material and non-disclosure could influence the economic decisions that users make on the basis of the financial statements.

❖ Although a constructive obligation is not created solely by a management decision, an obligation may result from other earlier events together with such a decision. For example, negotiations with employee representatives for termination payments, or with purchasers for the sale of an operation, may have been concluded subject only to board approval. Once that approval has been obtained and communicated to the other parties, the entity has a constructive obligation to restructure, if the conditions of the standard are met.

❖ In some countries, the ultimate authority is vested in a board whose membership includes representatives of interests other than those of management (e.g., employees) or notification to such representatives may be necessary before the board decision is taken. Because a decision by such a board involves communication to these representatives, it may result in a constructive obligation to restructure.

❖ No obligation arises for the sale of an operation until the entity is committed to the sale, i.e., there is a binding sale agreement.

❖ Even when an entity has taken a decision to sell an operation and announced that decision publicly, it cannot be committed to the sale until a purchaser has been identified and there is a binding sale agreement. Until there is a binding sale agreement, the entity will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms. When the sale of an operation is envisaged as part of a restructuring, the assets of the operation are reviewed for impairment under Ind AS 36. When a sale is only part of a restructuring, a constructive obligation can arise for the other parts of the restructuring before a binding sale agreement exists.

❖ A restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both:

(a) necessarily entailed by the restructuring; and

(b) not associated with the ongoing activities of the entity.

❖ A restructuring provision does not include such costs as:

(a) retraining or relocating continuing staff;

(b) marketing; or

(c) investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the end of the reporting period. Such expenditures should be recognised on the same basis as if they arose independently of a restructuring.

❖ Identifiable future operating losses up to the date of a restructuring are not included in a provision, unless they relate to an onerous contract.

❖ Gains on the expected disposal of assets should not be taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

Includes only the direct expenditures arising from the restructuring that are both:

(i) Necessarily entailed by restructuring

(ii) Not associated by the ongoing activities of the entity

Does not include such cost:

1. Retraining or Relocating continiung staff
2. Marketing or
3. Investment in new systems and distribution networks

Illustration 12

X Cements Ltd. has three manufacturing units situated in three different states of India. The board of directors of X Cements Ltd., in their meeting held on January 10, 20X1, decided to close down its operations in one particular state on account of environmental reasons. A detailed formal plan for *shutting down the above unit was also formalised and agreed by the board of directors in that meeting, which specifies the approximate number of employees who will be compensated and expenditure expected to be incurred. Date of implementation of plan has also been mentioned. Meetings were also held with customers, suppliers, and workers to communicate the features of the formal plan to close down the operations in the said state, and representatives of all interested parties were present in those meetings. Do the actions of the board of directors create a constructive obligation that needs a provision for restructuring?*

Solution

As per Ind AS 37, the conditions prescribed are:

(a) there should be detailed formal plan of restructuring;

(b) which should have raised valid expectations in the minds of those affected that the entity would carry out the restructuring by announcing the main features of its plans to restructure.

The board of directors did discuss and formalise a formal plan of winding up the operation in the above said state. This plan was communicated to the parties affected and created a valid expectation in their minds that X Cements Ltd. would go ahead with its plans to close down operations in that state. Thus, there is a constructive obligation that needs to be provided at year-end.

*****

2.12 DISCLOSURE

❖ For each class of provision, an entity should disclose:

(a) the carrying amount at the beginning and end of the period;

(b) additional provisions made in the period, including increases to existing provisions;

(c) amounts used (i.e., incurred and charged against the provision) during the period;

(d) unused amounts reversed during the period; and

(e) the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

Comparative information is not required to be disclosed.

❖ An entity should disclose the following for each class of provision:

(a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;

(b) an indication of the uncertainties about the amount or timing of those outflows.

Where necessary to provide adequate information, an entity should disclose the major assumptions made concerning future events; and

(c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

❖ Unless the possibility of any outflow in settlement is remote, an entity should disclose for each class of contingent liability at the end of the reporting period a brief description of the nature of the contingent liability and, where practicable:

(a) an estimate of its financial effect, measured in the standard;

(b) an indication of the uncertainties relating to the amount or timing of any outflow; and

(c) the possibility of any reimbursement.

❖ In determining which provisions or contingent liabilities may be aggregated to form a class, it is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfill the requirements of the standard and

- Thus, it may be appropriate to treat as a single class of provision amounts relating to warranties of different products, but it would not be appropriate to treat as a single class amounts relating to normal warranties and amounts that are subject to legal proceedings.
- Where a provision and a contingent liability arise from the same set of circumstances, an entity makes the disclosures required by the standard in a way that shows the link between the provision and the contingent liability.
- Where an inflow of economic benefits is probable, an entity should disclose a brief description of the nature of the contingent assets at the end of the reporting period, and, where practicable, an estimate of their financial effect, measured using the principles set out for provisions in the standard.
- It is important that disclosures for contingent assets avoid giving misleading indications of the likelihood of income arising.
- Where any of the information required by the standard is not disclosed because it is not practicable to do so, that fact should be stated.
- In extremely rare cases, disclosure of some or all of the information required can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose the information, but should disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

Illustration 13 - Warranties

A manufacturer gives warranties at the time of sale to purchasers of its three product lines. Under the terms of the warranty, the manufacturer undertakes to repair or replace items that fail to perform satisfactorily for two years from the date of sale. At the end of the reporting period, a provision of ₹ 60,000 has been recognised. The provision has not been discounted as the effect of discounting is not material. Draft the Note.

Solution

A provision of ₹ 60,000 has been recognised for expected warranty claims on products sold during the last three financial years. It is expected that the majority of this expenditure will be incurred in the next financial year, and all will be incurred within two years after the reporting period.

*****

2.13 LEVIES (APPENDIX C OF IND AS 37)

2.13.1 Appendix C deals with

- the accounting for a liability to pay a levy if that liability is within the scope of Ind AS 37
- accounting for a liability to pay a levy whose timing and amount is certain.

2.13.2 Appendix C does not deal with

- the accounting for the costs that arise from recognising a liability to pay a levy.

Note: Entities should apply other Standards to decide whether the recognition of a liability to pay a levy gives rise to an asset or an expense.

2.13.3 What is a Levy?

A charge imposed by governments on entities in accordance with laws and/or regulations. It leads to outflow of resources embodying economic benefits

It excludes

- outflows of resources that are within the scope of other Ind AS
- fines or other penalties that are imposed for breaches of the legislation
- payment made to the government for acquiring assets or for rendering services as per the contractual agreement
- liabilities that arise from emissions trading schemes.

Note: Government' refers to government, government agencies and similar bodies whether local, national or international.

2.13.4 Accounting Principles

- If and activity triggers the payment of the levy, it will be considered as an obligating event that gives rise to a liability to pay a levy

  Example

  If the activity that triggers the payment of the levy is the generation of revenue in the current period and the calculation of that levy is based on the revenue that was generated in a previous period, the obligating event for that levy is the generation of revenue in the current period. The generation of revenue in the previous period is necessary, but not sufficient, to create a present obligation.

- Any compulsion to operate in future will not be considered as constructive obligation for an entity, to pay a levy.
- The preparation of financial statements under the going concern assumption does not imply that an entity has a present obligation to pay a levy that will be triggered by operating in a future period.

- The liability to pay a levy is recognised progressively if the obligating event occurs over a period of time (ie if the activity that triggers the payment of the levy, as identified by the legislation, occurs over a period of time).

Example

If the obligating event is the generation of revenue over a period of time, the corresponding liability is recognised as the entity generates that revenue.

- If an obligation to pay a levy is triggered when a minimum threshold is reached, the accounting for the liability that arises from that obligation shall be consistent with the principles established in the standard

Example

If the obligating event is the reaching of a minimum activity threshold (such as a minimum amount of revenue or sales generated or outputs produced), the corresponding liability is recognised when that minimum activity threshold is reached.

- An entity shall apply the same recognition principles in the interim financial report that it applies in the annual financial statements. As a result, in the interim financial report, a liability to pay a levy:

  (a) shall not be recognised if there is no present obligation to pay the levy at the end of the interim reporting period; and

  (b) shall be recognised if a present obligation to pay the levy exists at the end of the interim reporting period.

- An entity shall recognise an asset if it has prepaid a levy but does not yet have a present obligation to pay that levy.

2.14 SIGNIFICANT DIFFERENCES IN IND AS 37 VIS-A-VIS AS 29

S. No.	Particulars	Ind AS 37	AS 29
1.	*Constructive obligations and Change in the Definition of Provision and Obligating Event*	Ind AS 37 requires creation of provisions in respect of constructive obligations. Definitions of provision and obligating event have been revised in Ind AS 37, while the terms 'legal obligation' and 'constructive obligation' have been inserted and defined in Ind AS 37. Similarly, the portion of existing AS 29 pertaining to restructuring	AS 29 requires creation of provisions in respect of constructive obligations also. It requires creation of provisions arising out of normal business practices, custom and a desire to maintain good business relations or to act in an equitable manner

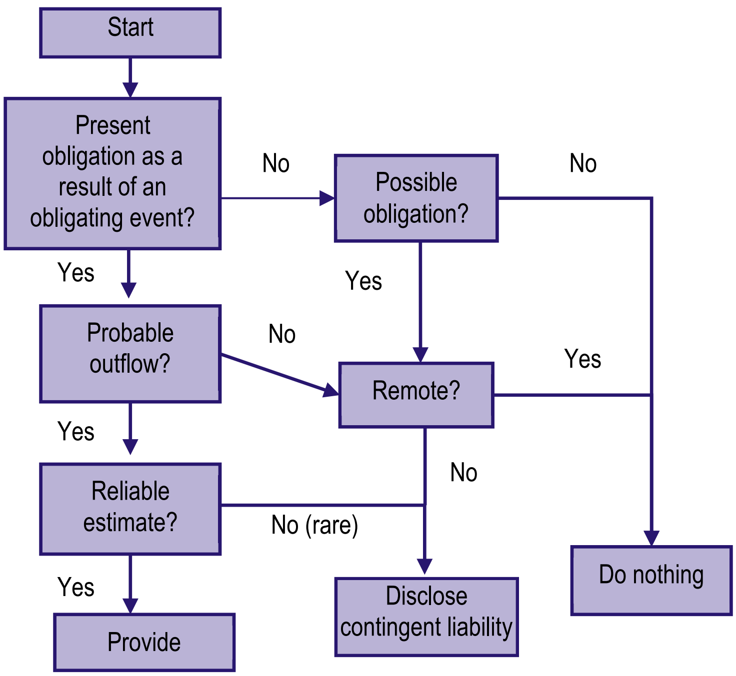
		provisions has been revised in Ind AS 37.	
2.	*Discounting*	When the effect of time value of money is material, discounting is required.	Discounting is not permitted except for decommissioning, restoration and similar liabilities associated with property, plant and equipment
3.	*Contingent asset*	Contingent assets are not recognised but disclosed in the financial statements when an inflow of economic benefits is probable.	Contingent assets are neither recognised nor disclosed in the financial statements and are usually disclosed as part of Board of Directors' report.
4.	*Onerous Contracts:*	Ind AS 37 makes it clear that before a separate provision for an onerous contract is established, an entity should recognise any impairment loss that has occurred on assets dedicated to that contract in accordance with Ind AS 36.	There is no such specific provision in the existing standard
5.	*Future Operating Losses:*	Ind AS 37 gives an exception to this principle viz. such losses related to an onerous contract.	AS 29 states that identifiable future operating losses up to the date of restructuring are not included in a provision.
6.	*Additional guidance*	Ind AS 37 gives guidance on: (a) Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds (b) Liabilities arising from Participating in a Specific Market — Waste Electrical and Electronic Equipment (c) Levies (imposed by government).	AS 29 does not give such guidance.

QUICK RECAP

Provisions	Contingent liability	Contingent asset

• Present legal or constructive obligation as a result of a past event
• Probable outflow of economic benefits to settle the obligation
• Obligation can be estimated reliably
	• Possible obligations arising from a past event to be confirmed by future events not wholly within the control of the entity, or
	• Present obligations arising from a past event
	    • of which the outflow of economic benefits is not probable, or
	    • that cannot be measured reliably
		• Possible assets arising from a past event to be confirmed by future events not wholly within control of entity

Decision tree



The purpose of this diagram is to summarise the main recognition requirements of Ind AS 37 for provisions and contingent liabilities.

Note: In rare cases, it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the end of the reporting period.

TEST YOUR KNOWLEDGE

Questions

1. In 2017, an entity involved in nuclear activities recognises a provision for decommissioning costs of ₹ 300 million. The provision is estimated using the assumption that decommissioning will take place in 60–70 years' time. However, there is a possibility that it will not take place until 100–110 years' time, in which case the present value of the costs will be significantly reduced. Draft the note.

2. An entity is involved in a dispute with a competitor, who is alleging that the entity has infringed patents and is seeking damages of ₹ 100 million. The entity recognises a provision for its best estimate of the obligation, but discloses none of the information required by the standard. Draft the note.

3. X Ltd. is operating in the telecom industry. During the Financial Year 20X1-20X2, the Income Tax authorities sent a scrutiny assessment notice under Section 143(2) of the Income-tax Act, 1961, in respect to return filed under Section 139 of this Act for Previous Year 20X0-20X1 (Assessment Year 20X1-20X2) and initiated assessment proceedings on account of a deduction claimed by the company which in the view of the authorities was inadmissible.

   During the financial year 20X1-20X2 itself, the assessment proceedings were completed and the assessing officer did not allow the deduction and raised a demand of ₹ 1,00,00,000 against the company. The company contested such levy and filed an appeal with the Appellate authority. At the end of the financial year 20X1-20X2, the appeal had not been heard. The company is not confident whether that the company would win the appeal. However, the company was advised by its legal counsel that on a similar matter, two appellate authorities of different jurisdictions had given conflicting judgements, one in favour of the assessee and one against the assessee. The legal counsel further stated it had more than 50% chance of winning the appeal. Please advise how the company should account for these transactions in the financial year 20X1-20X2.

4. An entity is a telecom operator. Laying of cables across the world is a requirement to enable the entity to run its business. Cables are also laid under the sea and contracts are entered into for the same. By virtue of laws of the countries through which the cable passes, the entity is required to restore the sea bed at the end of the contract period. What is the nature of obligation that the entity has in such a case?

5. Entity A is a dealer in washing machines. Entity A offers to its customers a scheme whereby it states that after a period of 3 years, the entity offers to buy back the washing machine at a fixed price which is expected to be less than the fair value of the machine at the end of three years. The credit emanating therefrom will be required to be used by the customer for buying a new washing machine, i.e., new washing machine will be sold at a discounted price.

Past experience indicates that customers generally opt for this scheme. At the time of sale of the first washing machine should entity A recognise any provision in this regard?

Answers

1. A provision of ₹ 300 million has been recognised for decommissioning costs. These costs are expected to be incurred between 2077 and 2087; however, there is a possibility that decommissioning will not take place until 2117–2127. If the costs were measured based upon the expectation that they would not be incurred until 2117–2127 the provision would be reduced to ₹ 136 million. The provision has been estimated using existing technology, at current prices, and discounted using a real discount rate of 2%.

2. Litigation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed patents and is seeking damages of ₹ 100 million. The information usually required by Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets, is not disclosed on the grounds that it can be expected to prejudice seriously the outcome of the litigation. The directors are of the opinion that the claim can be successfully resisted by the company.

3. Ind AS 37 provides that in rare cases it not clear whether there is a present obligation, for example, in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an entity should determine whether a present obligation exits at the end of the reporting period by taking account of all available evidence, for example, the opinion of experts.

In the present case, the company is not confident that whether it would win the appeal. By taking into account the opinion of the legal counsel, it is not sure that whether the company would win the appeal. On the basis of such evidence, it is more likely than not that a present obligation exists at the end of the reporting period. Therefore, the entity should recognise a provision. The company should provide for a liability of ₹ 1,00,00,000.

4. Paragraph 14 of Ind AS 37 states "A provision shall be recognised when:

(a) an entity has a present obligation (legal or constructive) as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision shall be recognised."

Further, with regard to past event paragraph 17 of Ind AS 37 states "A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only:

(a) where the settlement of the obligation can be enforced by law; or

(b) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation."

On the basis of the above, provision should be recognised as soon as the obligating event takes place because the entity is under legal obligation to restore the sea bed, provided the other recognition criteria stated in paragraph 14 reproduced above are met. Moreover, the amount of the provision would depend on the extent of the obligation arising from the obligating event. In the instant case, an obligating event is the laying of cables under the sea. To the extent the cables have been laid down under the sea, a legal obligation has arisen and to that extent provision for restoration of sea bed should be recognised.

5. Paragraph 14 of Ind AS 37 states "A provision shall be recognised when:

(a) an entity has a present obligation (legal or constructive) as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision shall be recognised."

In the instant case, assuming that the entity recognises the entire revenue on the sale of first washing machine, a provision for expected cost of meeting the obligation of selling the second machine at discounted price should be recognised because sale of first washing machine is the past event.

Moreover, past experience indicates that customers generally opt for this scheme, therefore, probability of outflow of resources is more likely than not. Since it is a normal practice which the entity follows, reliable estimate of the amount of meeting the obligation can also be made.

CHAPTER 10

IND AS ON ITEMS IMPACTING THE FINANCIAL STATEMENTS

UNIT 1: INDIAN ACCOUNTING STANDARD 12 : INCOME TAXES

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand the objective and scope of the standard
- Define the terms used in the standard like accounting profit, taxable profit (tax loss), tax expense (tax income), current tax, deferred tax liabilities, deferred tax assets, temporary differences, taxable temporary differences, deductible temporary differences and the tax base
- Recognise current tax liabilities and current tax assets
- Recognise deferred tax liabilities and deferred tax assets
- Appreciate when Ind ASs permit or require certain assets to be carried at fair value or to be revalued
- Identify the situations where temporary difference may arise on initial recognition of an asset or liability
- Recognise deferred tax asset for all deductible temporary differences
- Evaluate the cases, when a deferred tax asset arises on initial recognition of an asset

- Measure current tax liabilities (assets) for the current and prior periods
- Measure deferred tax assets and liabilities using the tax rates
- Identify the items recognised outside profit or loss
- Calculate the deferred tax arising from a business combination
- Calculate current and deferred tax arising from share-based payment transactions
- Account for tax assets and tax liabilities
- Offset tax assets with tax liabilities
- Present the tax expense in the Statement of Profit and Loss with respect to various transactions
- Disclose the major components of tax expense (income)
- Account for the Income Taxes on account of changes in the tax status of an entity or its shareholders.

UNIT OVERVIEW

Definition	• Accounting profit • Taxable profit (tax loss) • Tax expense (tax income) • Current tax • Deferred tax liabilities • Deferred tax assets • Temporary differences • Taxable temporary differences • Deductible temporary differences • Tax base
Tax Expense	• Current Tax • Deferred Tax
Current tax	• Recognition • Measurement • Accounting of Current Tax Effects • Offsetting Current Tax Assets and Current Tax Liabilities
Deferred Tax	• Compute carrying amount • Compute tax base • Compute temporary differences • Classify temporary differences • Identify exceptions • Assess (also reassess) deductible temporary differences, tax losses and tax credits • Determine the tax rate (law) • Calculate and recognise deferred tax • Accounting of deferred tax • Offsetting deferred tax assets and deferred tax liabilities
Practical Application	• Deferred tax arising from a business combination • Current and deferred tax arising from share-based payment transactions • Change in tax status of an entity or its shareholders
Disclosure	• Disclose components of tax expenses (income) • Tax related to items charged directly to equity • Tax related to items recognised in statement of other comprehensive income • Explanation of the relationship between tax expense (income) and accounting profit • Change in tax rates • Unrecognised deductible temporary differences, unused tax losses and unused tax credits • Temporary differences associated with investments in subsidiaries etc. • Amount of deferred tax liabilities (assets) or income (expense)

1.1 INTRODUCTION

There was a time in India, few decades back when the concept of zero income tax entities was prevalent. Due to various income tax benefits, these companies had no current tax liability for any income tax that was payable based on that year's accounting profit. Thus, no provision of income tax was created. Profit after tax used to be equal to profit before tax. But from accounting perspective, this was not a correct reflection of results. Quite a few of these tax benefits were primarily accelerated benefits.

For example, depreciation was deductible in taxation on written down value method (WDV) whereas in the books of accounts, entities could claim depreciation on straight line method (SLM). As everybody knows that under WDV method, in initial years' depreciation charge is greater than depreciation under SLM. This resulted into accounting profits but no taxable profits. But over the useful life of the asset, depreciation under both methods is equal. In later years, depreciation charge under SLM would be higher than in depreciation under WDV. Therefore, in later years, in such a situation, the taxable profits will be higher than the book profits. This will require a higher tax provision in books when compared to the accounting profits of that year. Basically, this differential will be due to non-provision of tax liability in an earlier year.

Example 1:

An entity has acquired an asset for ₹ 10,000. The depreciation rate as per income tax is 40% on WDV basis. In books of account, entity claims depreciation on equivalent SLM basis of 16.21%. The entity has accounting and taxable profits of ₹ 20,000 from year 1 to year 4, inclusive, before any allowance of depreciation in either case.

The tax rate is 30%. Assuming no concept of deferred tax, the provision for current tax would be computed as under:

Year	1	2	3	4
Cost of the asset	10,000	10,000	10,000	10,000
Depreciation rate – WDV	40%	40%	40%	40%
Depreciation amount – WDV	4,000	2,400	1,440	864
Taxable profits before depreciation	20,000	20,000	20,000	20,000
Less: Depreciation	(4,000)	(2,400)	(1,440)	(864)
Taxable profits after depreciation	16,000	17,600	18,560	19,136
Tax rate	30%	30%	30%	30%
Tax amount	4,800	5,280	5,568	5,741

However, in the books of accounts, the situation will be as under:

Year	1	2	3	4
(a) Cost of the asset	10,000	10,000	10,000	10,000
(b) Depreciation rate – SLM	16.21%	16.21%	16.21%	16.21%

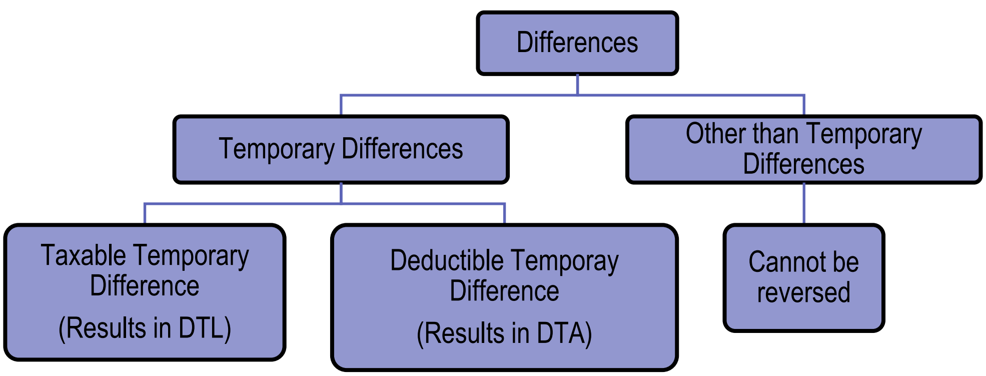
(c) Depreciation amount – SLM	1,621	1,621	1,621	1,621
(d) Accounting profits before depreciation	20,000	20,000	20,000	20,000
(e) Less: Depreciation	(1,621)	(1,621)	(1,621)	(1,621)
(f) Accounting profits after depreciation	18,379	18,379	18,379	18,379
(g) Tax amount – as above	4,800	5,280	5,568	5,741
(h) Effective tax rate=(g)/(f)	26.12%	28.73%	30.30%	31.24%
(i) Tax provision @ 30% tax rate {30%*(f)}	5,514	5,514	5,514	5,514

Thus, from the above two tables, for an accountant the tax should be ₹ 5,514 in all cases as per the accounting profit. The results are distorted. You will observe that in year 3, in books, the amount of tax provision is higher by ₹ 54 (5,568 – 5,514) and in year 4, it is higher by ₹ 227 (5,741 - 5,514). This is so because in year 1 & 2, these figures are lower by ₹ 714 (5,514 – 4,800) & ₹ 234 (5,514 – 5,280). Thus, the liability that was incurred in year 1 & 2 is paid year 3 onwards. However, no provision of the differential (₹ 714 in year 1 & ₹ 234 in year 2) is made.

The provision of differential should have been made by the entity following three major accounting concepts and convention of periodicity, matching and accrual. The entity has merely deferred the payment of tax to subsequent year. This understanding and appreciation of situation gave rise to the concept of deferred tax liabilities or deferred tax assets.

In earlier years, deferred tax was recognised based on concepts of timing differences and permanent differences based on differences in accounting profits and taxable profits known as income tax liability method. This concept stands revised with this Accounting Standard which recognised deferred tax based on temporary differences that arises due to difference in the carrying value of an item of asset or liability as per books of accounts with the carrying value of that item as per income tax provisions, known as tax base. This method is known as balance sheet approach.

This Accounting Standard though titled as 'income taxes' primarily deals with deferred tax though guidance is provided on current tax.



1.2 SCOPE

- The objective of this Standard is to prescribe the accounting treatment for income taxes. Income taxes for the purpose of this Standard includes:

  (a) all domestic and foreign taxes which are based on taxable profits;

  (b) taxes, such as withholding taxes (Tax Deducted at Source), which are payable by a subsidiary, associate or joint venture on distributions to the reporting entity.

Domestic and Foreign Taxes; Including withholding taxes which are payable by a subsidiary, Associate or Joint Arrangements on distributions to the Reporting Entity	Methods of Accounting for Government Grants or Investment tax credits (But it deals with accounting for temporary differences arising from such grants and investment tax credits)

- Further, the income-tax for the purpose of this Standard could be classified as:

  (a) ***Current tax*** being current tax consequence that arises due to transactions and other events of the current period that are recognised in an entity's financial statements.

  (b) ***Deferred tax*** being future tax consequence that arises due to the future (i) recovery of the carrying amount of assets or (ii) settlement of carrying amount of the liabilities that are recognised in an entity's balance sheet. For example: Recovery of fixed assets means by way of depreciation or sale and for other assets by way of realization.

- Before we proceed further, it is essential to understand the fundamental principle in recognising deferred tax. This is enunciated in the Standard as under:

  It is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. If it is probable that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, this Standard requires an entity to recognise a deferred tax liability (deferred tax asset).

Let us try to understand the aforesaid principle with the help of an example:

(a) Whenever an entity recognises an asset, it expects that it will recover the carrying value of that asset. For example, if an entity recognises an item of land at ₹ 1,00,000, it expects that it will be able to recover at least ₹ 1,00,000 if that land is sold is sometime in future.

(b) The income tax provisions, assuming, provides that if this piece of land is sold after one year, there will be an indexation benefit @ 10% per year. Thus, if the land is sold after one year, the cost of the land will for the purpose of taxation will be assumed at ₹ 1,10,000 (₹ 1,00,000 + 10%). If it is sold after two years, the cost of the land for the purpose of taxation will be assumed at ₹ 1,21,000 (₹ 1,10,000 + 10%).

(c) The tax rate in all years continues to be flat 30%.

(d) Thus, the recovery of the carrying value of land after two years will result into a tax saving of ₹ 6,300 i.e. 30% of 21000 (121000-100000).

(e) Thus, if after two and half year, land is sold for ₹ 1,50,000, the entity will pay a tax of ₹ 8,700 at 30% of ₹ 29,000 (₹ 1,50,000 – ₹ 1,21,000). If there would have been no indexation benefits, the tax liability would have been ₹ 15,000 at 30% of ₹ 50,000 (₹ 1,50,000 – ₹ 1,00,000). Saving in tax is of ₹ 6,300 (15,000-8,700).

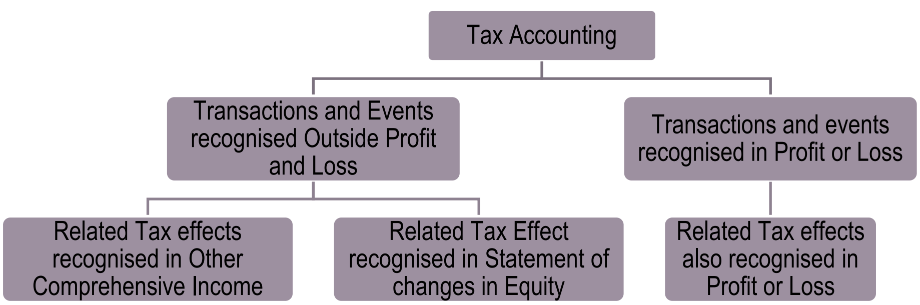
(f) The entity should recognise a deferred tax asset of ₹ 6,300 in this case.

(g) This principle has to be applied to each item of asset or liability.

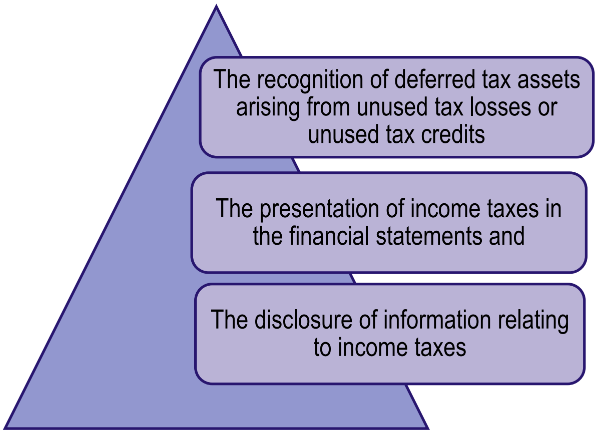
Note: There are controversial view in case of Indexation of land for a temporary difference because if the land is not going to be sold in a near future particularly in business then in such case it is not advisable to calculate temporary difference.

- The Standard also provides guidance as to where the current tax or deferred tax should be recognised, accounted and presented.
- An entity may incur a loss in the current period and set off against a profit in the earlier period. As the entity would recover a tax paid in the earlier year, the entity should recognize the benefit of tax recoverable as an asset.
- Items of current tax or defer tax recognized in profit and loss are subject to two exceptions:

  1. An item of current tax or defer tax pertaining to other comprehensive income should be recognized in other comprehensive income
  2. An item of current tax or defer tax pertaining to direct equity should be recognized in direct equity



- In addition, the Standard deals with the:
  (a) recognition of deferred tax assets arising from unused tax losses or unused tax credits;
  (b) presentation of income taxes in the financial statements; and
  (c) disclosure of information relating to income taxes.



- The Standard however, **does not deal** with the methods of accounting for government grants (see Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance*) or investment tax credits. However, it deals with the accounting for temporary differences that may arise from such grants or investment tax credits.

1.3 DEFINITIONS

Having understood, the basic concepts of current tax and deferred tax, the following definitions needs to be appreciated:

(a) ***Accounting profit*** is profit or loss for a period before deducting tax expense.

(b) ***Taxable profit (tax loss)*** is the profit (loss) for a period, computed as per the income tax act, upon which income taxes are payable (recoverable).

(c) ***Tax expense (tax income)*** is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.

(d) ***Current tax*** is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

(e) ***Deferred tax liabilities*** are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

(f) ***Deferred tax assets*** are the amounts of income taxes recoverable in future periods in respect of:

- deductible temporary differences;
- the carry forward of unused tax losses; and
- the carry forward of unused tax credits.

(g) ***Temporary differences*** are differences between the carrying amount of an asset or liability in the balance sheet and its tax base.

(h) ***Temporary differences*** may be either:

- **taxable temporary differences,** which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or
- **deductible temporary differences,** which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

(i) The **tax base** of an asset or liability is the carrying amount to that asset or liability for tax purposes.

To facilitate, easy understanding, this chapter has been divided as under:

(a) Part A : Tax Expense

(b) Part B : Current Tax, its Recognition, Measurement and Presentation

(c) Part C : Deferred Tax, its Recognition, Measurement and Presentation

(d) Part D : Practical Application

(e) Part E : Disclosures

1.4 PART A: TAX EXPENSE (TAX INCOME)

- Tax expense or tax income is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.
- The following needs to be appreciated:

  (a) Tax expense could be positive or negative. Thus, there could be a tax income.

  (b) Tax expense is the aggregate of:

  - **current tax; and**
  - **deferred** tax.

1.5 PART B: CURRENT TAX, ITS RECOGNITION, MEASUREMENT AND PRESENTATION

1.5.1 Current Tax

Current tax is the amount of *income taxes* payable (recoverable) in respect of the *taxable profit (tax loss)* for a period.

1.5.2 Recognition

(a) Current tax liability

- Current tax for current and prior periods shall, to the extent unpaid, be recognised as a liability.
- The exact liability of current tax crystallises only on preparation and finalisation of financial statements at the end of the reporting period.
- Any excess of this liability over the prepaid taxes (advance tax) and withhold taxes (TDS) is to be treated as current liability. This liability may be for the current reporting period or may relate to earlier reporting periods.

(b) Current tax assets

If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognised as an asset.

1.5.3 Measurement

(a) Current tax liabilities (assets) for the current and prior periods shall be measured at the amount <u>*expected*</u> to be paid to (recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted.

(b) Uncertain tax position interpretations

- An entity computes its current income-taxes in accordance with the provisions contained in the taxation laws. Taxation laws provide certain benefits or require enhancements in accordance with the fiscal, economic and other policies of the country. These at times are prone to varying interpretations and settled by the appellate authorities after a considerable period from the reporting period. The taxability remains uncertain.
- Ind AS 12 requires that current tax liabilities or assets for the current period or the period should be computed based on the amount it expects to pay. It is suggested that statistical tools may be used in computing the current tax with respect to the uncertain tax interpretations.

- Thus, computation of current tax at best is an estimate. Any change in this estimate based on subsequent developments should be treated as a change in estimate in accordance with Ind AS 8.

(c) Enacted or substantive enacted

- The tax rates in computing the current tax should be based on taxation laws that have enacted or substantively enacted.
- A proposed legislation is enacted when all the formalities with respect to the legislation is completed. In India, the enactment occurs when the legislation is notified in the gazette on and from the date it comes into force as mentioned in the said gazette notification.
- Implicit in the word 'substantively enacted' is the emphasis that in the relevant situation the enactment process is not fully completed. The process of enactment of a taxation laws in India is as under:
  - Finance bill is presented in Lok Sabha of Indian Parliament.
  - It is discussed and passed by the Lok Sabha.
  - It then moves to Rajya Sabha of Indian Parliament.
  - It is discussed in the Rajya Sabha.
  - It is then presented before the President for assent.
  - It is then notified in the gazette of India.
- Now, at which stage an entity should conclude that the legislation is substantively enacted becomes a key consideration. More so, the finance bill in India is normally presented on the last day of February and is enacted by the 3rd week of May. The reporting period of most of the entities ends on 31st March and listed entities attempt to issue their financial statements within 4-6 weeks of the reporting date.
- Ind AS 12 does not provide any guidance.
- It is therefore suggested that the entity should explicitly disclose in its financial statements the accounting policy with respect to the adoption of tax rates based on the principle of 'substantive enactment'. Needless to add, the policy should be applied consistently. If material, the variation due to adoption of rates based on 'substantive enactment' should also be disclosed.

1.5.4 Accounting of Current Tax Effects

(a) The accounting of current tax effects of a transaction of an event is consistent with the accounting for that transaction or event.

(b) The current tax effects of a transaction shall follow its accounting treatment if the item is recognised in statement of profit or loss, its current tax effect will be recognised in statement of profit or loss.

(c) For further discussion on this topic, refer Accounting for Deferred Tax.

1.5.5 Offsetting Current Tax Assets and Current Tax Liabilities

(a) An entity shall offset current tax assets and current tax liabilities if, and only if, the entity:

- has a legally enforceable right to set off the recognised amounts; and
- intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

(b) Although current tax assets and liabilities are separately recognised and measured they are offset in the balance sheet subject to criteria similar to those established for financial instruments in Ind AS 32. An entity will normally have a legally enforceable right to set off a current tax asset against a current tax liability when they relate to income taxes levied by the same taxation authority and the taxation laws permit the entity to make or receive a single net payment.

(c) In consolidated financial statements, a current tax asset of one entity in a group is offset against a current tax liability of another entity in the group if, and only if, the entities concerned have a legally enforceable right to make or receive a single net payment and the entities intend to make or receive such a net payment or to recover the asset and settle the liability simultaneously.

1.6 PART C: DEFERRED TAX, ITS RECOGNITION, MEASUREMENT AND PRESENTATION

The following steps should be followed in the recognition, measurement and presentation of deferred tax liabilities or assets:

Step 1: Compute carrying amounts of assets and liabilities

Step 2: Compute tax base

Step 3: Compute temporary differences

Step 4: Classify temporary differences into either:

- Taxable temporary difference
- Deductible temporary difference

Step 5: Identify exceptions

Step 6: Assess deductible temporary differences, tax losses and tax credits

Step 7: Determine the tax rate

Step 8: Calculate and recognise deferred tax

Step 9: Accounting of deferred tax

Step 10: Offsetting of deferred tax liabilities and deferred tax assets

These are now discussed in detail.

1.6.1 Step 1: Compute carrying amount

For the purpose of this Standard, we can define carrying amount at which an asset or liability is recognised in the balance sheet, after making necessary adjustments like depreciation, impairment, etc. In other words, carrying amount of the assets and liabilities means balance as per the ledger.

Example

Entity A had acquired an item of plant and machinery for ₹ 1,00,000 on 1st April, 20X1. It depreciated this item @ 10% per annum on SLM basis. For the year ended 31st March, 20X2, it provides depreciation of ₹ 10,000. The carrying amount of this item of plant and machinery as on 31st March, 20X2 is ₹ 90,000.

1.6.2 Step 2: Compute tax base

(a) The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.

Example

Entity A had acquired an item of plant and machinery for ₹ 1,00,000 on 1st April1, 20X1. It depreciated this item @ 10% per annum on SLM basis. For the year ended 31st March, 20X2, it provides depreciation of ₹ 10,000. The carrying amount of this item of plant and machinery as on 31st March, 20X2 is ₹ 90,000. As per taxation laws, this item of plant and machinery has to be depreciated @ 30% per annum on WDV basis. The entity thus for the purposes of taxation computes depreciation of ₹ 30,000. The tax base of this item of plant and machinery is ₹ 70,000 (₹ 1,00,000 – ₹ 30,000).

(b) Four scenarios could be anticipated for computation of the tax base of either an asset or a liability:

- Tax base of an asset.
- Tax base of a liability.
- Items with a tax base but no carrying amount.
- Items of assets and liabilities where tax base is not apparent.

Let us examine and compute tax base under each of the four scenarios:

(i) Tax base of an asset

The principle to compute tax base of an asset is as under:

- The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset.
- The carrying amount of the asset could be recovered either through sale of the asset or through its use or partly through use and partly through sale. The method of recovery has to be determined at each reporting date.

Example

Entity A has inventory with carrying amount of ₹ 1,00,000 as at the reporting date. It recovers the value of inventory through sale in a subsequent reporting period. The sale value is the economic benefit derived by the entity and is taxable. However, as per the matching and other concepts, against this sale the entity is entitled to deduct its cost. The cost is the carrying amount of the inventory i.e., ₹ 1,00,000. The tax base in this case is ₹ 1,00,000.

Example

Entity A has acquired an item of asset for ₹ 1,00,000 for production of certain items to be sold by the entity. It is deductible equally over two years in the books of accounts. The carrying amount as the end of first reporting period is ₹ 50,000 (₹ 1,00,000 – ₹ 50,000). In the income tax, ₹ 75,000 is deductible in year 1 and balance is deductible in year 2. We have to compute its tax base as on the last day of the first reporting period. However, in income-tax, it can claim only ₹ 25,000 being 25% of the cost of the asset as 75% has already been claimed in year 1. Thus, the tax base in this case is ₹ 25,000.

Example

Interest receivable have a carrying amount of 100. The related interest revenue will be taxed on a cash basis. The tax base of the interest receivable is nil.

Example

An entity that follows mercantile system of accounting has trade receivables of ₹ 1,000. It creates a general bad debt allowance of ₹ 50. The carrying amount in the books of accounts of trade receivables is thus ₹ 950. However, in income-tax, general bad debt provision is not deductible. In the subsequent period, entity is able to recover only ₹ 950. The amount recovered is a taxable economic benefit. But for tax purposes, entity is entitled for a deduction of ₹ 1,000 against this recovery of trade receivable. The tax base is ₹ 1,000.

Example

An entity that follows mercantile system of accounting has trade receivables of ₹ 1,000. It creates a specific bad debt of ₹ 50. The carrying amount in the books of accounts of trade receivables is thus ₹ 950. However, in income-tax, specific bad debt provision is deductible in the very year it is created. In the subsequent period, entity is able to recover only ₹ 950. The amount recovered is a taxable economic benefit. For tax purposes, entity will be entitled for a deduction of ₹ 950 against this recovery of trade receivable; ₹ 50 already deducted in the earlier period. The tax base is ₹ 950.

- If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount.
- It is quite feasible that in certain cases, the economic benefits that are derived from the recovery of an asset are not taxable. In these situations, the tax base of the asset is taken at its carrying amount.

Example

An entity has an investment in listed equity shares. There is no tax on gains that arise on sale of these listed equity shares. Thus, the tax base in this case will be the carrying amount of the investments.

Example

An entity has given a loan of ₹ 10,000 which is the carrying amount. The repayment of loan has no tax consequences. The tax base is ₹ 10,000.

(ii) Tax base of a liability

The principle to compute tax base of a liability is as under:

- The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods.

Example

Current liabilities include accrued expenses with a carrying amount of ₹ 100. The related expense will be deducted for tax purposes on a cash basis.

The tax base of the accrued expenses is nil.

Example

Current liabilities include accrued expenses with a carrying amount of ₹ 100. The related expense has already been deducted for tax purposes.

The tax base of the accrued expenses is ₹ 100.

- If those liabilities are not tax deductible, the tax base of that liability is equal to its carrying amount.

Example

Current liabilities include accrued fines and penalties with a carrying amount of ₹ 100. Fines and penalties are not deductible for tax purposes.

The tax base of the accrued fines and penalties is ₹ 100.

❖ It is an other than temporary difference, as the expenses are not allowable as per income tax.

Example

A loan payable has a carrying amount of ₹ 100. The repayment of the loan will have no tax consequences.

The tax base of the loan is ₹ 100.

❖ In the case of revenue which is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods.

Example

Current liabilities include interest revenue received in advance, with a carrying amount of ₹ 100. The related interest revenue was taxed on a cash basis.

The tax base of the interest received in advance is nil.

(iii) Items with a tax base but no carrying amount

❖ There are certain items that have a tax base but no carrying amount. These include items that are charged to revenue statement in the period in which they are incurred but are allowed as a deduction over a number of periods as per the taxation laws.

Example

A Limited has been incorporated recently. It incurred ₹ 1,00,000 on its incorporation. It has been charged to revenue in the very first accounting period. The taxation laws allow deduction over a period of 5 years. The carrying amount at the end of year 1 is Nil.

The tax base will be ₹ 80,000 (20,000 x 4) as ₹ 20,000 being 1/5th is allowable as a deduction in taxation laws over 4 years.

Example

Public issue expenses. The entity may have written off the public issue expenses in the very first year. But since tax laws permit deduction over 5 years, the temporary differences will exist till complete deduction is claimed in taxation laws.

(iv) Items of assets and liabilities where tax base is not apparent

- There could be situations where it may be difficult to compute the tax base of an item. One however, knows the carrying amount. This is because of the provisions of taxation laws. Whereas in books of accounts, all or most of the revenue and gains are included as part of one single performance statement, in the taxation laws they are charged under different head. The taxable amount amongst other things depends under which head an item at the time of recovery may be charged. In India, income or gains are charged either as 'Salaries', 'Income from house property', 'Profits and gains of business', 'Capital Gain' & 'Income from other sources'. Further certain specific or weighted deductions are also permissible. For example, rental income is subject to a flat deduction. So how will you compute the rental income received in advance? Moreover, there are cases depending upon the substance of the transaction, the rental income is to be charged as business income. At times, reverse may be the case. Many more similar situations could be anticipated.

Example

Entity A has an industrial undertaking that consists of land, building, plant and machinery. It is contemplating disposing the entity. It has the option to recover the carrying amount of the entity either by disposing the entire entity as a slump sale or dispose of each asset on a piecemeal basis. Depending upon the manner of recovery and period of holding, the carrying amount may be subject to indexation benefit, the recovery may be charged either as a business profit or capital gains. Again it could be long term gain capital gain or short term capital gain. As at the end of the reporting period, the entity is not sure of the manner and time of recovery.

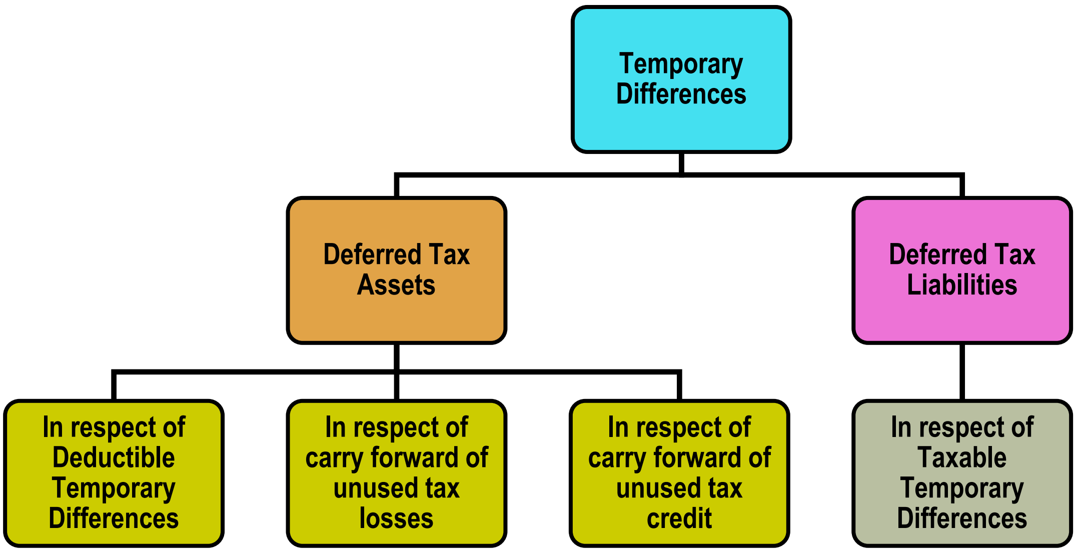
- So, how should one proceed with the determination of the tax base? It is a matter of judgment. The Standard states that one should refer the fundamental principle as enumerated in the Standard. The principle is reproduced hereunder:

  It is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. If it is probable that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, this Standard requires an entity to recognise a deferred tax liability (deferred tax asset)

- It is recommended, if material, the basis of judgment and related uncertainties should be disclosed.

(c) Tax base is determined with reference to the tax returns of each entity. This poses no problems when computing tax base of a standalone entity. In some jurisdiction, taxation laws, in the case of a group permits a consolidated tax return. In such cases, tax bases should be determined based on a consolidated tax returns. If this is not so, then the basis should be individual tax returns. The carrying amount in both the cases shall be determined on the basis of consolidated financial statements.

1.6.3 Step 3: Compute temporary differences



(a) Hitherto, in India, entities have been determining deferred tax based on Accounting Standard (AS) 22, *Accounting for Taxes on Income,* as notified in Companies (Accounting Standards) Rules, 2006. The concept there is of 'timing difference' and 'permanent difference'. Based upon the nature of difference, deferred tax liabilities or assets are recognised. The Ind AS 12 is based on the concept of temporary difference. As per Ind AS 12, there are only temporary differences, no permanent differences and timing differences are a component of temporary differences. The concept of 'temporary differences' is core of this Ind AS.

(b) The term temporary difference is defined as the difference between the carrying amount of an asset or liability in the balance sheet and its tax base.

Example

An entity has an item of plant and machinery acquired on the first day of the reporting period for ₹ 1,00,000. It depreciates it @ 20% p.a on SLM basis. The carrying amount in balance sheet is ₹ 80,000. The taxation laws require depreciation @ 30% on WDV basis. The tax base at the end of the reporting period is ₹ 70,000. The temporary difference is ₹ 10,000 (₹ 80,000 – ₹ 70,000).

(c) The contention in favor of temporary difference is that at the end of the day, all differences between the carrying amount and tax base of an asset or liability will reverse. At most the entity may be able to delay the timing of reversal but the difference will ultimately have reversed, therefore the term 'temporary difference' is used. The cumulative impact is 'zero'.

Example

An entity acquires an asset on the first day of reporting period for ₹ 120 with a useful life of 6 years and no residual value. It depreciates the asset on SLM basis. The tax rate is 30%. The tax depreciation is as assumed in the computation below.

The following computations are performed.

Financial Statements

Year	1	2	3	4	5	6
Gross Block	120	120	120	120	120	120
Cumulative Depreciation	(20)	(40)	(60)	(80)	(100)	(120)
Carrying Amount	100	80	60	40	20	0

Tax Computation

Year	1	2	3	4	5	6
Tax base brought forward	120	30	20	13	8	3
Depreciation charge (assumed)	(90)	(10)	(7)	(5)	(5)	(3)
Tax base carried forward	30	20	13	8	3	0

Temporary Difference

Year	1	2	3	4	5	6
Carrying Amount	100	80	60	40	20	0
Tax base carried forward	(30)	(20)	(13)	(8)	(3)	0
Temporary difference	70	60	47	32	17	0
Cumulative impact	+70	–10	–13	–15	–15	–17
	+70	–70				

Movement in Balance Sheet

Year	1	2	3	4	5	6
Temporary difference @ 30%	70	60	47	32	17	0
Deferred tax liability	21	18	14	10	5	0
Movement in provision	+21	-3	-4	-4	-5	-5
Cumulative	+21	-21				

(d) To some, it may appear that temporary differences and timing differences are one and the same term. It is not so. It can however, be said that temporary difference includes timing differences. Timing differences arise when income or expense is included in accounting profit in one period but is included in taxable profit in a different period.

(e) Examples of temporary differences in the nature of timing differences are as under.

Example

Interest income recognized in income statement on a time proportion basis but recognized in taxable profit on cash basis as and when income is received.

Example

Depreciation used in determining taxable income may differ from that used in determining accounting profit.

Example

Development costs may be capitalized and amortize over future periods in determining accounting profit but deducted in determining taxable profit in the period in which they are incurred.

(f) Examples of temporary differences other than in the nature of timing differences are as under:

Example : Business combinations

The identifiable assets acquired and liabilities assumed in a business combination are recognised at their fair values in accordance with Ind AS 103, *Business Combinations,* but no equivalent adjustment is made for tax purposes.

With limited exceptions, the identifiable assets acquired and liabilities assumed in a business combination are recognised at their fair values at the acquisition date. Temporary differences arise when the tax bases of the identifiable assets acquired and liabilities assumed are not affected by the business combination or are affected differently.

For example, when the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner, a taxable temporary difference arises which results in a deferred tax liability. However, it may be noted that the resulting deferred tax liability affects goodwill.

Example : *Revaluation: assets are revalued and no equivalent adjustment is made for tax purposes.*

Indian Accounting Standards permit or require certain assets to be carried at fair value or to be revalued (see, for example, Ind AS 16, *Property, Plant and Equipment*, Ind AS 38, *Intangible Assets*, Ind AS 109, *Financial Instruments* ***and Ind AS 116 Leases***).

In some jurisdictions, the revaluation or other restatement of an asset to fair value affects taxable profit (tax loss) for the current period. As a result, the tax base of the asset is adjusted and no temporary difference arises.

In other jurisdictions, the revaluation or restatement of an asset does not affect taxable profit in the period of the revaluation or restatement and, consequently, the tax base of the asset is not adjusted.

Nevertheless, the future recovery of the carrying amount will result in a taxable flow of economic benefits to the entity and the amount that will be deductible for tax purposes will differ from the amount of those economic benefits. The difference between the carrying amount of a revalued asset and its tax base is a temporary difference and gives rise to a deferred tax liability or asset.

This is true even if:

(a) the entity does not intend to dispose of the asset. In such cases, the revalued carrying amount of the asset will be recovered through use and this will generate taxable income which exceeds the depreciation that will be allowable for tax purposes in future periods; or

(b) tax on capital gains is deferred if the proceeds of the disposal of the asset are invested in similar assets. In such cases, the tax will ultimately become payable on sale or use of the similar assets.

1.6.4 Step 4: Classify temporary differences

(a) Temporary differences are to be classified into:

- Taxable temporary differences
- Deductible temporary differences

(b) Taxable temporary differences are those temporary differences that results in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

As the name 'taxable temporary difference' suggests, these are the temporary differences that will be taxed in future. These taxable temporary differences will increase tax liabilities. All taxable temporary differences, subject to limited exceptions, give rise to deferred tax liability.

Taxable temporary difference arises where the:

- carrying amount of an asset exceeds its tax base; or
- tax base of a liability exceeds its carrying amount.

Example

An asset which costs ₹ 150 has a carrying amount of ₹ 100. Cumulative depreciation for tax purposes is ₹ 90 and the tax rate is 25%.

The tax base of the asset is ₹ 60 (cost of ₹ 150 less cumulative tax depreciation of ₹ 90). To recover the carrying amount of ₹ 100, the entity must earn taxable income of ₹ 100, but will only be able to deduct tax depreciation of ₹ 60. Consequently, the entity will pay income taxes of ₹ 10 (₹ 40 at 25%) when it recovers the carrying amount of the asset. The difference between the carrying amount of ₹ 100 and the tax base of ₹ 60 is a taxable temporary difference of ₹ 40.

(c) Deductible temporary differences are those temporary differences that results in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

Again, it should be noted, the name 'deductible temporary difference' suggests, these are the temporary differences that will be deducted in future when computing the tax liability. These deductible temporary differences will reduce tax liabilities. All deductible temporary differences, subject to exceptions/recognition criteria, give rise to deferred tax assets.

Deductible temporary difference arises where the:

- carrying amount of a liability exceeds its tax base; or
- tax base of an asset exceeds its carrying amount.

Example

An entity recognises a liability of ₹ 100 for gratuity and leave encashment expenses by creating a provision for gratuity and leave encashment. For tax purposes, any amount with regard to gratuity and leave encashment will not be deductible until the entity pays the same. The tax rate is 25%.

The tax base of the liability is nil (carrying amount of ₹ 100, less the amount that will be deductible for tax purposes in respect of that liability in future periods). In settling the liability for its carrying amount, the entity will reduce its future taxable profit by an amount of ₹ 100 and, consequently, reduce its future tax payments by ₹ 25 (₹ 100 at 25%). The difference between the carrying amount of ₹ 100 and the tax base of nil is a deductible temporary difference of ₹ 100.

(d) Based on the above discussions, a matrix as under may be drawn:

	For Assets	For Liabilities
If carrying amount > tax base	Taxable Temporary Difference ↓ Deferred Tax Liability (e.g. WDV as per books > WDV as per Income Tax)	Deductible Temporary Difference ↓ Deferred Tax Asset (e.g. Provision for Bonus as per books > Provision for Bonus as per IT)

If carrying amount < tax base	Deductible Temporary Difference ↓ Deferred Tax Asset (e.g. WDV as per books < WDV as per Income Tax)	Taxable Temporary Difference ↓ Deferred Tax Liability (e.g. Loan carrying amount as per books< Loan carrying amounts as per tax)
If carrying amount = tax base	No temporary difference	No temporary difference

(e) Further examples of taxable temporary differences:

- **Transactions that affect profit or loss**

Example

Interest revenue is received in arrears and is included in accounting profit on a time apportionment basis but is included in taxable profit on a cash basis.

Example

Revenue from the sale of goods is included in accounting profit when goods are delivered but is included in taxable profit when cash is collected.

In this case, there is also a deductible temporary difference associated with any related inventory.

Example

Depreciation of an asset is accelerated for tax purposes.

Example

Development costs have been capitalised and will be amortised to the statement of profit and loss but were deducted in determining taxable profit in the period in which they were incurred.

Example

Prepaid expenses have already been deducted on a cash basis in determining the taxable profit of the current or previous periods.

- **Transactions that affect the balance sheet**

Example

Depreciation of an asset is not deductible for tax purposes and no deduction will be available for tax purposes when the asset is sold or scrapped.

Example

A borrower records a loan at the proceeds received (which equal the amount due at maturity), less transaction costs. Subsequently, the carrying amount of the loan is increased by amortisation of the transaction costs to accounting profit. The transaction costs were deducted for tax purposes in the period when the loan was first recognised.

Example

A loan payable was measured on initial recognition at the amount of the net proceeds, net of transaction costs. The transaction costs are amortised to accounting profit over the life of the loan. Those transaction costs are not deductible in determining the taxable profit of future, current or prior periods.

Example

The liability component of a compound financial instrument (for example a convertible bond) is measured at a discount to the amount repayable on maturity (see Ind AS 32, *Financial Instruments: Presentation*). The discount is not deductible in determining taxable profit (tax loss).

- **Fair value adjustments and revaluation**

Example

Financial assets are carried at fair value which exceeds cost but no equivalent adjustment is made for tax purposes.

Example

An entity revalues property, plant and equipment (under the revaluation model treatment in Ind AS 16, *Property, Plant and Equipment*) but no equivalent adjustment is made for tax purposes.

- **Business combinations and consolidation**

Example

The carrying amount of an asset is increased to fair value in a business combination and no equivalent adjustment is made for tax purposes.

Example

Reductions in the carrying amount of goodwill are not deductible in determining taxable profit and the cost of the goodwill would not be deductible on disposal of the business.

Example

Unrealised losses resulting from intragroup transactions are eliminated by inclusion in the carrying amount of inventory or property, plant and equipment.

Example

Retained earnings of subsidiaries, branches, associates and joint ventures are included in consolidated retained earnings, but income taxes will be payable if the profits are distributed to the reporting parent.

Example

Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by changes in foreign exchange rates.

Example

The non-monetary assets and liabilities of an entity are measured in its functional currency but the taxable profit or tax loss is determined in a different currency.

- **Hyperinflation**

Example

Non-monetary assets are restated in terms of the measuring unit current at the end of the reporting period (see Ind AS 29, *Financial Reporting in Hyperinflationary Economies*) and no equivalent adjustment is made for tax purposes.

(f) Further examples of deductible temporary differences:

- **Transactions that affect profit or loss**

Example

Retirement benefit costs are deducted in determining accounting profit as service is provided by the employee, but are not deducted in determining taxable profit until the entity pays either retirement benefits or contributions to a fund. *(note: similar deductible temporary differences arise where other expenses, such as gratuity and leave encashment or interest, are deductible on a cash basis in determining taxable profit.)*

Example

Accumulated depreciation of an asset in the financial statements is greater than the cumulative depreciation allowed up to the end of the reporting period for tax purposes.

Example

The cost of inventories sold before the end of the reporting period is deducted in determining accounting profit when goods or services are delivered but is deducted in determining taxable profit when cash is collected. *(it may be noted, there is also a taxable temporary difference associated with the related trade receivable.)*

Example

The net realisable value of an item of inventory, or the recoverable amount of an item of property, plant or equipment, is less than the previous carrying amount and an entity therefore reduces the carrying amount of the asset, but that reduction is ignored for tax purposes until the asset is sold.

Example

Preliminary expenses (or organisation or other start-up costs) are recognised as an expense in determining accounting profit but are not permitted as a deduction in determining taxable profit until a later period.

Example

Income is deferred in the balance sheet but has already been included in taxable profit in current or prior periods.

Example

A government grant which is included in the balance sheet as deferred income will not be taxable in future periods.

- **Fair value adjustments and revaluation**

Example

Financial assets are carried at fair value which is less than cost, but no equivalent adjustment is made for tax purposes.

- **Business combinations and consolidation**

Example

A liability is recognised at its fair value in a business combination, but none of the related expense is deducted in determining taxable profit until a later period.

Example

Unrealised profits resulting from intragroup transactions are eliminated from the carrying amount of assets, such as inventory or property, plant or equipment, but no equivalent adjustment is made for tax purposes.

Example

Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by changes in foreign exchange rates.

Example

The non-monetary assets and liabilities of an entity are measured in its functional currency but the taxable profit or tax loss is determined in a different currency.

❖ Deferred tax liabilities are created for all taxable temporary differences with limited exceptions. Similarly, deferred tax assets are created for all deductible temporary differences subject to limited exceptions and recognition criteria. In Step 5 we will discuss the exceptions with respect to creation to deferred tax and in Step 6 we will discuss the recognition criteria area for deferred tax assets. However, before we proceed further, let's discuss the principle in recognising deferred tax liabilities or deferred tax asset.

❖ These are:

(a) Deferred tax liability

- A deferred tax liability shall be recognized for all taxable temporary differences, except to the extent that the deferred tax liability arises from:

  (a) the initial recognition of goodwill; or

  (b) the initial recognition of an asset or liability in a transaction which:

    (i) is not a business combination; and

    (ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss)

- However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, a deferred tax liability shall be recognised in accordance with paragraph 39 of Ind AS 12.

(b) Deferred tax asset

- A deferred tax asset shall be recognized for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:

  (a) is not a business combination; and

  (b) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

- However, for deductible temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, a deferred tax asset shall be recognised in accordance with paragraph 44 of Ind AS 12.

❖ From a reading of the aforesaid principles, deferred tax liabilities and deferred tax assets needs to be recognised in most of the cases. But the recognition of deferred tax liabilities or deferred tax assets are subject to exceptions with respect to the following items:

(a) the initial recognition of goodwill arising in a business combination (exception 1);

(b) the initial recognition of an asset or liability in a transaction which:

(i) is not a business combination; and

(ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss) (exception 2);

(c) temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures (exception 3).

These exceptions are discussed in Step 5.

❖ Also deferred tax assets should be created only to the extent of the probability of availability of taxable profits. In case, this probability of availability of taxable profits is missing, deferred tax assets should not be created. The profit probability recognition criterion is discussed in Step 6.

1.6.5 Step 5: Identify exceptions

(a) Exception 1: The initial recognition of goodwill in the case of a business combination

- In the case of a business combination, when the consideration paid exceeds the net identifiable assets, goodwill is created.
- Technically speaking, goodwill arising in a business combination is measured as the excess of (a) over (b) below:

  (a) the aggregate of:

  (i) the consideration transferred measured in accordance with Ind AS 103, which generally requires acquisition date fair value;

  (ii) the amount of any non-controlling interest in the acquiree recognized in accordance with Ind AS 103; and

  (iii) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

  (b) the net of the acquisition-date amounts of the identifiable assets acquired and liabilities assumed measured in accordance with Ind AS 103.
- As per principles enunciated in this Ind AS 12, the entity has to determine the tax base of this goodwill to compute the temporary difference, either taxable or deductible, at the time of recognition and subsequently when impairment takes place. The Standard provides separate guidance for taxable temporary difference (Situation A) and deductible temporary difference (Situation B).
- **Situation A:** Where the temporary difference is in the nature of taxable temporary difference. Again in this case, the prescribed treatment is different where good will is not tax deductible (Situation A1) and where it is tax deductible (Situation A2).

- **(Situation A1: Where it is not tax deductible)**

  (a) At the time of initial recognition of goodwill:

  (i) Quite a few tax jurisdictions do not permit this goodwill as a tax deductible expense. Also, the cost of goodwill is often not deductible when a subsidiary dispose of its underlying business. Put simply, the tax base of goodwill is Nil. But the entity has a taxable temporary difference as the goodwill (an asset) has a carrying amount leading to a deferred tax liability.

  (ii) The Standard does not permit the recognition of the resulting deferred tax liability as goodwill is measured as a residual and the recognition of the deferred tax liability would increase the carrying amount of goodwill, resulting into a circular type of computation.

Example

An entity acquires a subsidiary and pays ₹ 1,00,000. The fair value of net identifiable assets is ₹ 65,000. The following entry shall be made in the books:

Entry 1:

Goodwill	Dr.	35,000	
Net Assets	Dr.	65,000	
To Consideration			1,00,000

The tax base of goodwill is ₹ Nil. Hence the taxable temporary difference is ₹ 35,000. Assuming tax rate to be 30%, deferred tax liability of ₹ 10,500 needs to be created. Now because of recognition of this deferred tax liability, the following entry needs to be passed instead of the above entry:

Entry 2:

Goodwill	Dr.	45,500	
Net assets	Dr.	65,000	
To Consideration			1,00,000
To Deferred tax liability			10,500

The temporary difference now is ₹ 45,500 and not ₹ 35,000 and the resultant deferred tax liability should be ₹ 13,650 (45,500 x 30%) and not ₹ 10,500. Thus, deferred tax liability in entry 2 should be increased by ₹ 3,150 which in turn will increase goodwill by a similar amount with consequent impact on taxable temporary difference and deferred tax liability. The circle goes on.

Therefore, no deferred tax liability is to be recognised in the case of taxable temporary difference arising on the initial recognition of goodwill in a business combination in tax jurisdiction where such goodwill is not tax deductible.

(b) Subsequently at the time of impairment, if required, in the carrying amount:

(i) This goodwill as per Ind AS 103 is not amortised though tested for impairment.

(ii) Subsequent reduction in a deferred tax liability that is unrecognised because it arises from the initial recognition of goodwill is also regarded as arising from the initial recognition of goodwill and is therefore not recognised.

For example, in the aforesaid Example, after 2 years goodwill is tested for impairment and the entity recognises an impairment loss of ₹ 10,000, the amount of the taxable temporary difference relating to the goodwill is reduced from ₹ 35,000 to ₹ 25,000, with a resulting decrease in the value of the unrecognised deferred tax liability. That decrease in the value of the unrecognised deferred tax liability is also regarded as relating to the initial recognition of the goodwill and is therefore prohibited from being recognised as per this Ind AS 12.

- **Situation A2: Where it is tax deductible**

  In tax jurisdiction, where goodwill is tax deductible, deferred tax liability should be recognised for the taxable temporary difference.

- **Situation B: where the difference is in the nature of deductible difference**

  In all cases, deferred tax asset, subject to recognition criteria discussed in step 6 below, should be recognised.

- **Summary of Exception 1**

  No deferred tax liability is to be recognised for taxable temporary difference arising on goodwill arising in a business combination in tax jurisdictions where such goodwill is not tax deductible.

  In all other cases of temporary difference, either taxable or deferred, either deferred tax liability or deferred tax asset should be recognised in accordance with other provisions of this Ind AS.

(b) Exception 2: The initial recognition of an asset or liability in a transaction which: (i) is not a business combination; and (ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss)

- The Standard prohibits recognition of deferred tax liability or deferred tax assets in cases of either taxable or deductible temporary difference arising in a transaction:

  (a) is not a business combination; and

  (b) does not affect neither the accounting profit nor the taxable profit.

- As per the Standard, three types of transactions of assets or liabilities could be anticipated:

  Type 1: In the nature of business combination

  In such a case, recognise deferred tax liabilities or deferred tax assets on temporary differences between the carrying amount and respective tax base of assets or liabilities except on goodwill (in certain circumstances)

  Type 2: Where the transaction impacts accounting profit (i.e. statement of profit or loss) (like sale of goods, recognition of debtors)

  In such a case, recognise any deferred tax in statement of profit or loss:

  Type 3: Where the transaction is not a business combination & does not impact accounting profit nor taxable profit, such as purchase of assets or receipt of government grants.

  This exception relates to the transaction of the third type.

  Example

  Entity A acquires a foreign made vehicle for ₹ 1,00,000 directly from the vehicle manufacturer. The transaction is not a part of any business combination. The tax laws do not permit any depreciation thereon. Also, any profits at the time of sale are not taxable or losses are not tax deductible. This vehicle thus has a tax base of ₹ Nil. There is a taxable temporary difference of ₹ 1,00,000. Assuming a tax rate of 30%, the entity should create a deferred tax liability of ₹ 30,000. But the Standard does not permit.

- The Standard implies that if the carrying amount of any asset or liability is not equal to its tax base at the time of its transaction where the transaction is:

  (i) Not in the nature of business combination.

  (ii) Not impacting either the accounting profit or the taxable profit.

  (iii) Neither deferred tax liability nor deferred tax asset should be recognised.

- The following is a brief checklist:

  (i) Is the transaction in the nature of business combination?

  (ii) Whether the transaction impacts accounting profit?

  (iii) Whether the transaction impacts taxable profits?

  (iv) Whether the carrying amount is equal to tax base?

- Depending on the answers to the checklist, deferred tax asset or liability needs to be determined in accordance with the guidance under this exception.

- Furthermore, an entity does not recognise subsequent changes in unrecognised deferred tax liability or asset as the asset is depreciated.

(c) Exception 3: Temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures

- Temporary differences arise when the carrying amount of investments in subsidiaries, branches and associates or interests in joint ventures (namely the parent or investor's share of the net assets of the subsidiary, branch, associate or investee, including the carrying amount of goodwill) becomes different from the tax base (which is often cost) of the investment or interest.
- Such differences may arise in a number of different circumstances, for example:

  (i) the existence of undistributed profits of subsidiaries, branches, associates and joint ventures;

  (ii) changes in foreign exchange rates when a parent and its subsidiary are based in different countries; and

  (iii) a reduction in the carrying amount of an investment in an associate to its recoverable amount.

  In consolidated financial statements, the temporary difference may be different from the temporary difference associated with that investment in the parent's separate financial statements if the parent carries the investment in its separate financial statements at cost or revalued amount.

- Should an entity recognise a deferred tax liability in these cases? The guiding principle is:

  An entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, except to the extent that both of the following conditions are satisfied:

  (i) the parent, investor or venturer is able to control the timing of the reversal of the temporary difference; and

  (ii) it is probable that the temporary difference will not reverse in the foreseeable future.

  Now let us examine where the parent, investor or venture is able to control the timing of reversal of taxable temporary difference. Generally, the taxable temporary difference will get reversed on distribution of dividends.

- ***Subsidiary/branches*:** As a parent controls the dividend policy of its subsidiary, it is able to control the timing of the reversal of temporary differences associated with that investment (including the temporary differences arising not only from undistributed profits but also from any foreign exchange translation differences). Furthermore, it would often be impracticable to determine the amount of income taxes that would be payable when the temporary difference reverses. Therefore, when the parent has determined that those profits will not be distributed in the foreseeable future the parent does not recognise a deferred tax liability. The same considerations apply to investments in branches.

- The non-monetary assets and liabilities of an entity are measured in its functional currency (see Ind AS 21, *The Effects of Changes in Foreign Exchange Rates*) in the exchange rate which give rise to temporary differences that result in a recognised deferred tax liability or (subject to recognition criteria) asset. The resulting deferred tax is charged or credited to profit or loss.
- ***Associate*:** An investor in an associate does not control that entity and is usually not in a position to determine its dividend policy. Therefore, in the absence of an agreement requiring that the profits of the associate will not be distributed in the foreseeable future, an investor recognises a deferred tax liability arising from taxable temporary differences associated with its investment in the associate. In some cases, an investor may not be able to determine the amount of tax that would be payable if it recovers the cost of its investment in an associate, but can determine that it will equal or exceed a minimum amount. In such cases, the deferred tax liability is measured at this amount.
- ***Joint Venture*:** The arrangement between the parties to a joint venture usually deals with the sharing of the profits and identifies whether decisions on such matters require the consent of all the venturers or a specified majority of the venturers. When the venturer can control the sharing of profits and it is probable that the profits will not be distributed in the foreseeable future, a deferred tax liability is not recognised.

The aforesaid discussion related to recognition of deferred tax liability on taxable temporary difference. But there could be deductible temporary differences. So what is the guiding principle for recognition of deferred tax assets on deductible temporary differences?

- The principle is:

  An entity shall recognise a deferred tax asset for all deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint ventures, to the extent that, and only to the extent that, it is probable that:

  (i) the temporary difference will reverse in the foreseeable future; and

  (ii) taxable profit will be available against which the temporary difference can be utilised.

  Both the conditions have to be satisfied.
- In deciding whether a deferred tax asset is recognised for deductible temporary differences associated with its investments in subsidiaries, branches and associates, and its interests in joint ventures, an entity considers the guidance set out in Step 6 below.

1.6.6 Step 6: Assess (also reassess) deductible temporary differences, tax losses and tax credits

(a) As we are aware that deductible temporary differences reduce the taxable profits of future periods. It signifies that future tax payments will be smaller by a particular amount. However economic benefits will flow to the entity in the form of lower tax liability in future only in case it has future profits. If there are no future profits, it means there are no tax payments which in turn mean that deductible temporary differences are of no benefit.

Example

Entity A has deductible temporary difference of ₹ 1,00,000 for the financial year ended 31st March, 20X1. It anticipates a future profit of ₹ 3,00,000 in next year against which the said deductible temporary differences could be set off. The tax rate is 30%. Thus, in future the entity will pay tax on ₹ 2,00,000 (₹ 300,000 – ₹ 1,00,000). The tax liability is ₹ 60,000 @ 30% tax rate.

Had there been no deductible temporary difference, the tax liability would be ₹ 90,000 @ 30% on ₹ 300,000. Thus, there is an inflow of economic benefit of ` 30,000 through a lower cash outflow.

However, if there is no probability of taxable profits in future, the entity is not able to derive any economic benefit (by way of lower cash outflow in future) because of the existing of deductible temporary difference.

(b) Therefore, an entity should recognise deferred tax assets only when it is probable that taxable profits will be available against which the deductible temporary differences can be utilised. This is based on the principle of prudence and conservatism. It should be noted that the entity has to make sufficient taxable profits in future. Not making losses will not suffice.

(c) If tax law does not impose any restrictions on sources of taxable profits against which it may make deductions on the reversal of that deductible temporary difference, an entity assesses a deductible temporary difference in combination with all of its other deductible temporary differences.

(d) If tax law restricts the utilisation of losses to deduction against income of a specific type, a deductible temporary difference is assessed in combination only with other deductible temporary differences.

(e) Probable means more likely than not. The Standard provides a three step criteria to be applied in a serial order. The criterion is applied in the case of the same taxable entity assessed by the same taxation authority.

Criteria No. 1 : Existence of taxable temporary differences

The entity at the balance sheet should see whether there are sufficient taxable temporary differences whose reversal pattern matches with the reversal profile of deductible temporary differences.

Particulars	Year (₹)		
	1	2	3
Taxable temporary difference			
Opening balance	10,000	5,000	2,000
Recognised in taxable income	5,000	3,000	2,000
Closing balance	5,000	2,000	-
Deductible temporary difference			
Opening balance	8,000	4,000	1,000
Recognised in taxable income	4,000	3,000	1,000
Closing balance	4,000	1,000	-
Statement of taxable income			
Taxable temporary difference	5,000	3,000	2,000
Deductible temporary difference	4,000	3,000	1,000

The entity can recognise deferred tax assets for the entire deductible temporary differences.

Example

As at 31st March, 20X1, an entity has both taxable temporary differences and deductible temporary difference with the following reversal pattern. Deductible temporary differences cannot be carried forward.

Particulars	Year (₹)		
	1	2	3
Taxable temporary difference			
Opening balance	10,000	5,000	2,000
Recognized in taxable income	5,000	3,000	2,000
Closing balance	5,000	2,000	-
Deductible temporary difference			
Opening balance	8,000	4,000	-
Recognized in taxable income	4,000	4,000	-
Closing balance	4,000	-	-
Statement of taxable income			
Taxable temporary difference	5,000	3,000	2,000
Deductible temporary difference	4,000	4,000	-

The entity can recognize deferred tax assets for the deductible temporary differences up to ₹ 7,000 (₹ 4,000 for year 1 & ₹ 3,000 for year 2) as a taxable temporary difference of that amount is available.

Criteria No. 2: Probability of future profits

The entity has to apply probability criteria on its future profitability. If it is probable that there will be sufficient taxable profits, then to the extent of available profits, deductible temporary differences should be applied for recognition of deferred tax assets.

Example

If in the aforesaid example, the entity expects a profit of ₹ 750 in year 2, then deferred tax asset should be created on ₹ 7,750 (₹ 4,000 + ₹ 3,000 + ₹ 750).

However, taxable profits arising in future from future origination of deductible temporary differences should not be considered as deductible temporary differences will require future taxable profits for utilisation.

Example

An entity has unutilised deductible temporary difference of ₹ 1,000 at the end of year 1 that is going to be reversed in the year 2. In year 2, taxable profits are computed because of tax disallowances of unpaid statutory liabilities of ₹ 1,000 which can be claimed as deduction only in year 3, if paid, but cannot be carried forward. The entity expects nil taxable profit in year 3. In this case, no deferred tax asset will be created.

Example

An entity has unutilised deductible temporary difference of ₹ 1,000 at the end of year 1 that is going to be reversed in the year 2. In year 2, taxable profits are computed because of tax disallowances of unpaid statutory liabilities of ₹ 1,000 which can be claimed as deduction only in year 3, if paid, but cannot be carried forward. The entity expects taxable profit of ₹ 450 in year 3. In this case, deferred tax asset will be created at appropriate rate on deductible temporary difference of ₹ 450 only.

Criteria No. 3: Availability of tax planning opportunities

If even after applying criteria no. 2, still there are unrecognised deductible temporary differences, the entity endeavour to see whether any tax planning opportunities are available.

Tax planning opportunities are actions that the entity would take in order to create or increase taxable income in a particular period before the expiry of a tax loss or tax credit carry forward.

For example, in some jurisdictions, taxable profit may be created or increased by:

(i) electing to have interest income taxed on either a received or receivable basis;

(ii) deferring the claim for certain deductions from taxable profit;

(iii) selling, and perhaps leasing back, assets that have appreciated but for which the tax base has not been adjusted to reflect such appreciation; and

(iv) selling an asset that generates non-taxable income (such as, in some jurisdictions, a government bond) in order to purchase another investment that generates taxable income.

Where tax planning opportunities advance taxable profit from a later period to an earlier period, the utilisation of a tax loss or tax credit carry forward still depends on the existence of future taxable profit from sources other than future originating temporary differences.

(d) Unused tax losses and unused tax credits:

- A deferred tax asset shall be recognised for the carry forward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.
- The criteria for recognising deferred tax assets arising from the carry forward of unused tax losses and tax credits are the same as the criteria for recognising deferred tax assets arising from deductible temporary differences. However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity. In such circumstances, paragraph 82 of Ind AS 12 requires disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition.

(e) When an entity has a history of recent losses, the entity should consider the following guidance:

- The criteria for recognising deferred tax assets arising from the carry forward of unused tax losses and tax credits are the same as the criteria for recognising deferred tax assets arising from deductible temporary differences.
- However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity.
- In such circumstances, this Ind AS requires disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition.
- To assess the probability that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised, the entity should consider the following:

(i) whether the entity has sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, which will result in taxable amounts against which the unused tax losses or unused tax credits can be utilised before they expire;

(ii) whether it is probable that the entity will have taxable profits before the unused tax losses or unused tax credits expire;

(iii) whether the unused tax losses result from identifiable causes which are unlikely to recur; and

(iv) whether tax planning opportunities are available to the entity that will create taxable profit in the period in which the unused tax losses or unused tax credits can be utilised.

- To the extent that it is not probable that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised, the deferred tax asset is not to be recognised.

(f) Reassessment of unrecognised Deferred Tax Assets:

- At the end of each reporting period, the entity should reassess unrecognised deferred tax assets. It may need to recognise a previously unrecognised deferred tax asset to the extent it has now become probable that future taxable profits will be available for deferred tax assets to be recovered. For example, improvement in trading conditions may make it probable for an entity to generate sufficient taxable profits in future years to enable it to meet the recognition criteria laid down above.

(g) Uncertainty over income tax treatment

- ***In assessing whether and how an uncertain tax treatment affects the determination of taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates, an entity shall assume that a taxation authority will examine amounts it has a right to examine and have full knowledge of all related information when making those examinations.***

- ***If an entity concludes it is probable that the taxation authority will accept an uncertain tax treatment, the entity shall determine the taxable profit (tax loss), tax bases, unused tax losses, unused tax credits or tax rates consistently with the tax treatment used or planned to be used in its income tax filings.***

- ***If an entity concludes it is not probable that the taxation authority will accept an uncertain tax treatment, the entity shall reflect the effect of uncertainty in determining the related taxable profit (tax loss), tax bases, unused tax losses, unused tax credits or tax rates. An entity shall reflect the effect of uncertainty for each uncertain tax treatment by using either of the following methods, depending***

on which method the entity expects to better predict the resolution of the uncertainty:

(a) The most likely amount—the single most likely amount in a range of possible outcomes. The most likely amount may better predict the resolution of the uncertainty if the possible outcomes are binary or are concentrated on one value.

(b) The expected value—the sum of the probability-weighted amounts in a range of possible outcomes. The expected value may better predict the resolution of the uncertainty if there is a range of possible outcomes that are neither binary nor concentrated on one value.

- ***If an uncertain tax treatment affects current tax and deferred tax (for example, if it affects both taxable profit used to determine current tax and tax bases used to determine deferred tax), an entity shall make consistent judgements and estimates for both current tax and deferred tax.***

1.6.7 Step 7: Determine the tax rate (law)

(a) Having determined the taxable temporary differences and deductible temporary difference that needs to be considered for recognition of deferred tax liabilities or assets respectively, we now need to determine the tax for creation to deferred tax liabilities or assets. The principal is:

Deferred tax assets and liabilities shall be measured:

(i) at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled;

(ii) based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

(b) We have already discussed above the meaning of 'enacted' or 'substantively enacted'.

The same discussion applies here also. But another key word that needs to be understood in the principle is 'expected to apply'. Since, we are dealing in the future and future is uncertain, we have to measure this uncertainty. This leads to application of judgment. The tax rates or the tax laws that will apply in future depends on various factors such as manner of recovery of asset or settlement of liability, levels of income, distribution of profits among others. These are now discussed below.

It should however be remembered that the measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.

(c) Manner of recovery of asset or settlement of liability:

- In some jurisdictions, the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of (a) the tax rate applicable when the entity recovers (settles) the carrying amount of the asset (liability); and (b) the tax base of the asset (liability). In such cases, an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement.

Example

An asset has a carrying amount of ₹ 100 and a tax base of ₹ 60. A tax rate of 20% would apply if the asset was sold and a tax rate of 30% would apply to other income.

The entity recognises a deferred tax liability of ₹ 8 (₹ 40 at 20%) if it expects to sell the asset without further use or a deferred tax liability of ₹ 12 (₹ 40 at 30%) if it expects to retain the asset and recover its carrying amount through use.

Example

An asset with a cost of ₹ 100 and a carrying amount of ₹ 80 is revalued to ₹ 150. No equivalent adjustment is made for tax purposes. Cumulative depreciation for tax purposes is ₹ 30 and the tax rate is 30%. If the asset is sold for more than cost, the cumulative tax depreciation of ₹ 30 will be included in taxable income but sale proceeds in excess of cost will not be taxable.

The tax base of the asset is ₹ 70 and there is a taxable temporary difference of ₹ 80 (₹ 150 the revalued amount is the carrying amount).

If the entity expects to recover the carrying amount by using the asset, it must generate taxable income of ₹ 150, but will only be able to deduct depreciation of ₹ 70. On this basis, there is a deferred tax liability of ₹ 24 (₹ 80 at 30%).

If the entity expects to recover the carrying amount by selling the asset immediately for proceeds of ₹ 150, the deferred tax liability is computed as follows:

(i)	Sale proceeds	₹	150
(ii)	Sale proceeds in excess of cost (₹ 100)	₹	50
(iii)	Taxable proceeds	₹	100
(iv)	Tax base	₹	70
(v)	Taxable temporary difference	₹	30
(vi)	Tax rate		30%
(vii)	Deferred tax liability	₹	9

- Thus, the measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.

- However, an issue may arise as to how to interpret the term 'recovery' in relation to an asset that is not depreciated (non-depreciable asset) and is revalued in accordance with paragraph 31 (revaluation model) of Ind AS 16.
- **The accounting principle in this case is as under:**
  - ♦ The deferred tax liability or asset that arises from the revaluation of a non-depreciable asset in accordance with paragraph 31 of Ind AS 16 shall be measured on the basis of the tax consequences that would follow from recovery of the carrying amount of that asset through sale, regardless of the basis of measuring the carrying amount of that asset.
  - ♦ Accordingly, if the tax law specifies a tax rate applicable to the taxable amount derived from the sale of an asset that differs from the tax rate applicable to the taxable amount derived from using an asset, the former rate (tax rate applicable to the taxable amount derived from the sale of an asset) is applied in measuring the deferred tax liability or asset related to a non-depreciable asset.

(d) Levels of taxable income:

When different tax rates apply to different levels of taxable income, deferred tax assets and liabilities are measured using the average rates that are expected to apply to the taxable profit (tax loss) of the periods in which the temporary differences are expected to reverse.

(e) Distribution of dividends:

In some jurisdictions, income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In some other jurisdictions, income taxes may be refundable or payable if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. *In these circumstances, current and deferred tax assets and liabilities are measured at the tax rate applicable to undistributed profits*.

Example

The following example deals with the measurement of current and deferred tax assets and liabilities for an entity in a jurisdiction where income taxes are payable at a higher rate on undistributed profits (50%) with an amount being refundable when profits are distributed. The tax rate on distributed profits is 35%. At the end of the reporting period, 31st December, 20X1, the entity does not recognise a liability for dividends proposed or declared after the reporting period. As a result, no dividends are recognised in the year 20X1. Taxable income for 20X1 is ₹ 1,00,000. The net taxable temporary difference for the year 20X1 is ₹ 40,000.

The entity recognises a current tax liability and a current income tax expense of ₹ 50,000. No asset is recognised for the amount potentially recoverable as a result of future dividends.

The entity also recognises a deferred tax liability and deferred tax expense of ₹ 20,000 (₹ 40,000 at 50%) representing the income taxes that the entity will pay when it recovers or settles the carrying amounts of its assets and liabilities based on the tax rate applicable to undistributed profits.

Subsequently, on 15th March, 20X2 the entity recognises dividends of ₹ 10,000 from previous operating profits as a liability.

On 15th March, 20X2, the entity recognises the recovery of income taxes of ₹ 1,500 (15% of the dividends recognised as a liability) as a current tax asset and as a reduction of current income tax expense for 20X2.

1.6.8 Step 8: Calculate and recognise deferred tax

(a) This is the simplest of all steps. Having determined the taxable temporary differences and the deductible temporary differences as per Step 6 and the applicable tax rates with reference to tax laws, one has to multiply amount determined in Step 6 with the rates determined in Step 7.

- Taxable temporary differences when multiplied with tax rates will lead to deferred tax liabilities.
- Deductible temporary differences when multiplied with rates will lead to deferred tax assets.

(b) The following should be kept in mind:

- Deferred tax liabilities or assets should not be discounted.
- The carrying amount of a deferred tax asset shall be reviewed at the end of each reporting period.
- An entity shall reduce the carrying amount of a deferred tax asset to the extent that it is no longer probable that sufficient taxable profit will be available to allow the benefit of part or all of that deferred tax asset to be utilised.
- Any such reduction shall be reversed to the extent that it becomes probable that sufficient taxable profit will be available.

1.6.9 Step 9: Accounting of deferred tax

(a) The accounting of deferred tax effects of a transaction of an event is consistent with the accounting for that transaction or event.

(b) A transaction and the deferred tax effects of a transaction may be accounted for in:

- Statement of profit and loss;
- Outside profit and loss account:

(i) In other comprehensive income such as revaluation amount in accordance with Ind AS 16, *Property, Plant and Equipment*

(ii) Directly in equity such as correction of an error in accordance with Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors.*

(c) However, the carrying amount of deferred tax assets and liabilities may change even though there is no change in the amount of the related temporary differences.

- This can result, for example, from:
  - — a change in tax rates or tax laws;
  - — a reassessment of the recoverability of deferred tax assets; or
  - — a change in the expected manner of recovery of an asset.
- In such cases, the resulting deferred tax is recognised in profit or loss, except to the extent that it relates to items previously recognised outside profit or loss.

(d) In exceptional circumstances, it may be difficult to determine the amount of current and deferred tax that relates to items recognised outside profit or loss (either in other comprehensive income or directly in equity).

- This may be the case, for example, when a change in the tax rate or other tax rules affects a deferred tax asset or liability relating (in whole or in part) to an item that was previously recognised outside profit or loss; or
- In such cases, the current and deferred tax related to items that are recognised outside profit or loss are based on a reasonable pro rata allocation of the current and deferred tax of the entity in the tax jurisdiction concerned, or other method that achieves a more appropriate allocation in the circumstances.

(e) Ind AS 16 does not specify whether an entity should transfer each year from revaluation surplus to retained earnings an amount equal to the difference between the depreciation or amortisation on a revalued asset and the depreciation or amortisation based on the cost of that asset.

- If an entity makes such a transfer, the amount transferred is net of any related deferred tax.
- Similar considerations apply to transfers made on disposal of an item of property, plant or equipment.

(f) When an asset is revalued for tax purposes and that revaluation is related to an accounting revaluation of an earlier period, or to one that is expected to be carried out in a future period, the tax effects of both the asset revaluation and the adjustment of the tax base are recognised in other comprehensive income in the periods in which they occur.

(g) When an entity pays dividends to its shareholders, it may be required to pay a portion of the dividends to taxation authorities on behalf of shareholders. In many jurisdictions this amount is referred to as a withholding tax. Such an amount paid or payable to taxation authorities is charged to equity as a part of the dividends.

1.6.10 Step 10: Offsetting deferred tax assets and deferred tax liabilities

(a) An entity shall offset deferred tax assets and deferred tax liabilities if, and only if:

- the entity has a legally enforceable right to set off current tax assets against current tax liabilities; and
- the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority on either:
  - (i) the same taxable entity; or
  - (ii) different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realise the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered.

(b) To avoid the need for detailed scheduling of the timing of the reversal of each temporary difference, this Standard requires an entity to set off a deferred tax asset against a deferred tax liability of the same taxable entity if, and only if, they relate to income taxes levied by the same taxation authority and the entity has a legally enforceable right to set off current tax assets against current tax liabilities.

(c) In rare circumstances, an entity may have a legally enforceable right of set off, and an intention to settle net, for some periods but not for others. In such rare circumstances, detailed scheduling may be required to establish reliably whether the deferred tax liability of one taxable entity will result in increased tax payments in the same period in which a deferred tax asset of another taxable entity will result in decreased payments by that second taxable entity.

1.7 PART D: PRACTICAL APPLICATION

1.7.1 Deferred tax arising from a business combination

(a) As discussed above, temporary differences may arise in a business combination. In accordance with Ind AS 103, an entity recognises any resulting deferred tax assets (to the extent that they meet the recognition criteria) or deferred tax liabilities as identifiable assets and liabilities at the acquisition date. Consequently, those deferred tax assets and deferred tax liabilities affect the amount of goodwill or the bargain purchase gain the entity recognises. However, in accordance with this Ind AS, in certain circumstances, an entity does not recognise deferred tax liabilities arising from the initial recognition of goodwill.

(b) As a result of a business combination, the probability of realising a pre-acquisition deferred tax asset of the acquirer could change. An acquirer may consider it probable that it will recover its own deferred tax asset that was not recognised before the business combination. For example, the acquirer may be able to utilise the benefit of its unused tax losses against the future taxable profit of the acquiree. Alternatively, as a result of the business combination it might no longer be probable that future taxable profit will allow the deferred tax asset to be recovered. In such cases, the acquirer recognises a change in the deferred tax asset in the period of the business combination, but does not include it as part of the accounting for the business combination. Therefore, the acquirer does not take it into account in measuring the goodwill or bargain purchase gain it recognises in the business combination.

(c) The potential benefit of the acquiree's income tax loss carry forwards or other deferred tax assets might not satisfy the criteria for separate recognition when a business combination is initially accounted for but might be realised subsequently. An entity shall recognise acquired deferred tax benefits that it realises after the business combination as follows:

- Acquired deferred tax benefits recognised within the measurement period that result from new information about facts and circumstances that existed at the acquisition date shall be applied to reduce the carrying amount of any goodwill related to that acquisition. If the carrying amount of that goodwill is zero, any remaining deferred tax benefits shall be recognised in other comprehensive income and accumulated in equity as capital reserve or recognised directly in capital reserve, depending on whether paragraph 34 or paragraph 36A of Ind AS 103 would have applied had the measurement period adjustments been known on the date of acquisition itself.
- All other acquired deferred tax benefits realised shall be recognised in profit or loss (or, if this Standard so requires, outside profit or loss).

1.7.2 Current and deferred tax arising from share-based payment transactions

(a) In some tax jurisdictions, an entity receives a tax deduction (i.e., an amount that is deductible in determining taxable profit) that relates to remuneration paid in shares, share options or other equity instruments of the entity. The amount of that tax deduction may differ from the related cumulative remuneration expense, and may arise in a later accounting period. For example, in some jurisdictions, an entity may recognise an expense for the consumption of employee services received as consideration for share options granted, in accordance with Ind AS 102, *Share- based Payment*, and not receive a tax deduction until the share options are exercised, with the measurement of the tax deduction based on the entity's share price at the date of exercise.

(b) As with the preliminary expenses, the difference between the tax base of the employee services received to date (being the amount permitted as a deduction in future periods under taxation laws), and the carrying amount of nil, is a deductible temporary difference that results in a deferred tax asset. If the amount permitted as a deduction in future periods under taxation laws is not known at the end of the period, it shall be estimated, based on information available at the end of the period. For example, if the amount permitted as a deduction in future periods under taxation laws is dependent upon the entity's share price at a future date, the measurement of the deductible temporary difference should be based on the entity's share price at the end of the period.

(c) As noted above, in (a), the amount of the tax deduction or estimated future tax deduction, measured in accordance with paragraph (b) above may differ from the related cumulative remuneration expense. This Standard requires that current and deferred tax should be recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from (a) a transaction or event that is recognised, in the same or a different period, outside profit or loss, or (b) a business combination. If the amount of the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates not only to remuneration expense but also to an equity item. In this situation, the excess of the associated current or deferred tax should be recognised directly in equity.

1.7.3 Change in tax status of an entity or its shareholders

(a) A change in the tax status of an entity or of its shareholders may have consequences for an entity by increasing or decreasing its tax liabilities or assets. This may, for example, occur upon the public listing of an entity's equity instruments or upon the restructuring of an entity's equity. It may also occur upon a controlling shareholder's move to a foreign country. As a result of such an event, an entity may be taxed differently; it may for example gain or lose tax incentives or become subject to a different rate of tax in the future.

(b) A change in the tax status of an entity or its shareholders may have an immediate effect on the entity's current tax liabilities or assets. The change may also increase or decrease the deferred tax liabilities and assets recognised by the entity, depending on the effect the change in tax status has on the tax consequences that will arise from recovering or settling the carrying amount of the entity's assets and liabilities.

(c) The issue is how an entity should account for the tax consequences of a change in its tax status or that of its shareholders.

(d) The accounting principles that should be adopted in this situation are as under:

- A change in the tax status of an entity or its shareholders does not give rise to increases or decreases in amounts recognised outside profit or loss.
- The current and deferred tax consequences of a change in tax status shall be included in profit or loss for the period,
  - — unless those consequences relate to transactions and events that result,
  - — in the same or a different period,

— in a direct credit or charge to the recognised amount of equity or in amounts recognised in other comprehensive income.

- Those tax consequences that relate to changes in the recognised amount of equity, in the same or a different period (not included in profit or loss), shall be charged or credited directly to equity.
- Those tax consequences that relate to amounts recognised in other comprehensive income shall be recognised in other comprehensive income.

1.8 PART E: DISCLOSURES

This Ind AS not only deals with recognition and measurement of income-taxes but also requires quite a few disclosures with respect to these income tax. These are discussed as under.

1.8.1 Disclosure 1: Disclose components of tax expenses (income)

(a) Each of the major components of tax expense (income) is to be disclosed separately.

(b) As we know, tax expense (tax income) is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax. The tax expense (income) related to profit or loss or loss from ordinary activities shall be presented in statement of profit or loss.

(c) The components of tax expense (income) include:

- current tax expense (income);
- any adjustments recognised in the period for current tax of prior periods;
- the amount of deferred tax expense (income) relating to the origination and reversal of temporary differences;
- the amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes;
- the amount of the benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce current tax expense;
- the amount of the benefit from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce deferred tax expense;
- deferred tax expense arising from the write-down, or reversal of a previous write-down, of a deferred tax asset; and
- the amount of tax expense (income) relating to those changes in accounting policies and errors that are included in profit or loss in accordance with Ind AS 8, because they cannot be accounted for retrospectively.

1.8.2 Disclosure 2: Tax related to items charged directly to equity

(a) Indian Accounting Standards require or permit particular items to be credited or charged directly to equity.

(b) Examples of such items are:

- an adjustment to the opening balance of retained earnings resulting from either a change in accounting policy that is applied retrospectively or the correction of an error (see Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*); and
- amounts arising on initial recognition of the equity component of a compound financial instrument (see paragraph 23).

(c) The current and deferred tax relating to these items have to be recognised and accounted for directly in equity.

(d) This Ind AS requires disclosure of the aggregate current and deferred tax relating to items that are charged or credited directly to equity.

1.8.3 Disclosure 3: Tax related to items recognised in statement of other comprehensive income

(a) Indian Accounting Standards require or permit particular items to be recognised in other comprehensive income.

(b) Examples of such items are:

- a change in carrying amount arising from the revaluation of property, plant and equipment (see Ind AS 16); and
- exchange differences arising on the translation of the financial statements of a foreign operation (see Ind AS 21).

(c) The current and deferred tax relating to these items have to be recognised and accounted for in the statement of other comprehensive income.

(d) This Ind AS requires disclosure of the amount of income tax relating to each component of other comprehensive income.

1.8.4 Disclosure 4: Explanation of the relationship between tax expense (income) and accounting profit

(a) In ideal situation, if accounting profit is say ₹ 100 and tax rate is 30%, the tax expense should be ₹ 30. But this is seldom the case due to differences in accounting principles and standards vis–a–vis tax laws.

(b) Therefore, this Standard requires an explanation to be disclosed of the relationship between tax expense (income) and accounting profit in either or both of the following forms:

- a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed; or
- a numerical reconciliation between the average effective tax rate (tax expense divided by the accounting profit) and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed.

Example

An entity has made an accounting profit of ₹ 1,00,000. The tax rate is 30%. In computing the accounting profit, a penalty of ₹ 10,000 has been considered which is not tax deductible. There are no other tax impacts. In this case, the taxable profits are ₹ 1,10,000 (₹ 1,00,000 + ₹ 10,000) and tax expense @ 30% is ₹ 33,000.

The two types of disclosures are as under:

Particulars	Amount (₹)
Accounting profit	1,00,000
Tax at the applicable tax rate of 30%	30,000
Tax effect of expenses that are not deductible in determining taxable profits:	
Penalties	3,000
Tax expense	33,000

The effective tax rate is as per the national income-tax rate.

Particulars	%
Applicable tax rate	30
Tax effect of expenses that are not deductible in determining taxable profits - Penalties	3
Average effective tax rate	33

The effective tax rate is as per the national income-tax rate.

(c) These disclosures enable users of financial statements to understand whether the relationship between tax expense (income) and accounting profit is unusual and to understand the significant factors that could affect that relationship in the future. The relationship between tax expense (income) and accounting profit may be affected by such factors as revenue that is exempt from taxation, expenses that are not deductible in determining taxable profit (tax loss), the effect of tax losses and the effect of foreign tax rates.

(d) In explaining the relationship between tax expense (income) and accounting profit, an entity uses an applicable tax rate that provides the most meaningful information to the users of its financial statements. Often, the most meaningful rate is the domestic rate of tax in the country in which the entity is domiciled, aggregating the tax rate applied for national taxes with the rates applied for any local taxes which are computed on a substantially similar level of taxable profit (tax loss).

(e) However, for an entity operating in several jurisdictions, it may be more meaningful to aggregate separate reconciliations prepared using the domestic rate in each individual jurisdiction. The following example illustrates how the selection of the applicable tax rate affects the presentation of the numerical reconciliation.

Example

In 20X2, an entity has accounting profit in its own jurisdiction (country A) of ₹ 1,500 (20X1: ₹ 2,000) and in country B of ₹ 1,500 (20X1: ₹ 500). The tax rate is 30% in country A and 20% in country B. In country A, expenses of ₹ 100 (20X1: ₹ 200) are not deductible for tax purposes.

The following reconciliation will be prepared:

Particulars	Amount (₹)	
	20X2	**20X1**
Accounting profit	3,000	2,500
Tax at the domestic rate of 30%	900	750
Tax effect of expenses that are not deductible for tax purposes	30	60
Effect of lower tax rates in country B	(150)	(50)
Tax expense	780	760

1.8.5 Disclosure 5: Change in tax rates

(a) The applicable tax rates may change due to variety of reasons. There could be a change in the manner of recovery of the asset. The tax laws may have changed. There could be a change in the structure of the entity.

(b) In case there are changes in the applicable tax rate(s) compared to the previous accounting period, an explanation has to be provided.

1.8.6 Disclosure 6: Unrecognised deductible temporary differences, unused tax losses and unused tax credits

(a) The Standard lays down criteria for recognising deferred tax assets on deductible temporary differences, unused tax losses and unused tax credits. For example, whether a sufficient taxable temporary difference is available, is there a probability of future profits and are there any tax planning opportunities.

(b) If the laid down recognition criteria could not be met, no deferred tax asset is recognised on these deductible temporary differences, unused tax losses and unused tax credits.

(c) The Standard requires the amount (and expiry date, if any) of deductible temporary differences, unused tax losses, and unused tax credits for which no deferred tax asset is recognised in the balance sheet, to be disclosed.

1.8.7 Disclosure 7: Temporary differences associated with investments in subsidiaries etc.

(a) The aggregate amount of temporary differences associated with investments in subsidiaries, branches and associates and interests in joint ventures, for which deferred tax liabilities have not been recognised should be disclosed.

(b) It would often be impracticable to compute the amount of unrecognised deferred tax liabilities arising from investments in subsidiaries, branches and associates and interests in joint ventures. Therefore, this Standard requires an entity to disclose the aggregate amount of the underlying temporary differences but does not require disclosure of the deferred tax liabilities.

(c) Nevertheless, where practicable, entities are encouraged to disclose the amounts of the unrecognised deferred tax liabilities because financial statement users may find such information useful.

1.8.8 Disclosure 8: Amount of deferred tax liabilities (assets) or income (expenses)

(a) As per the criteria laid down in the Standard, deferred tax liabilities have to be recognised for taxable temporary differences and deferred tax assets have to be recognised for deductible temporary differences, unused tax losses and unused tax credits.

(b) Where deferred taxes have been recognised, the following should be disclosed in respect of each type of temporary difference, and in respect of each type of unused tax losses and unused tax credits:

- the amount of the deferred tax assets and liabilities recognised in the balance sheet for each period presented;
- the amount of the deferred tax income or expense recognised in profit or loss, if this is not apparent from the changes in the amounts recognised in the balance sheet.

1.8.9 Disclosure 9: Discontinued operations

The following should be disclosed in respect of discontinued operations, the tax expense relating to:

(i) the gain or loss on discontinuance; and

(ii) the profit or loss from the ordinary activities of the discontinued operation for the period, together with the corresponding amounts for each prior period presented.

1.8.10 Disclosure 10: Dividend tax

(a) At times dividends relating to the reporting period are proposed or declared after the reporting date but before the financial statements are approved for issue. These are disclosed but not recognised in financial statements.

(b) In such a situation, an entity should disclose the amount of income tax consequences of dividends to shareholders of the entity that were proposed or declared before the financial statements were approved for issue, but are not recognised as a liability in the financial statements.

1.8.11 Disclosures 11: In case of business combination

The following should be disclosed:

- if a business combination in which the entity is the acquirer causes a change in the amount recognised for its pre-acquisition deferred tax asset, the amount of that change; and
- if the deferred tax benefits acquired in a business combination are not recognised at the acquisition date but are recognised after the acquisition date, a description of the event or change in circumstances that caused the deferred tax benefits to be recognised.

1.8.12 Disclosure 12: Deferred tax asset and evidence thereto where based on future taxable profits

An entity shall disclose the amount of a deferred tax asset and the nature of the evidence supporting its recognition, when:

- the utilization of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences; and
- the entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.

1.8.13 Disclosure 13: Tax consequences of distribution of dividends

(a) As discussed above, in some tax jurisdiction tax rates depend on the fact whether dividend is distributed or not.

(b) In these circumstances, an entity shall disclose the nature of the potential income tax consequences that would result from the payment of dividends to its shareholders. In addition, the entity shall disclose the amounts of the potential income tax consequences practicably determinable and whether there are any potential income tax consequences not practicably determinable.

(c) The aforesaid disclosure requirement requires an entity to disclose the nature of the potential income tax consequences that would result from the payment of dividends to its shareholders. An entity also discloses the important features of the income tax systems and the factors that will affect the amount of the potential income tax consequences of dividends.

(d) However, it would sometimes not be practicable to compute the total amount of the of the total amount may be easily determinable. For example, in a consolidated group, a parent and some of its subsidiaries may have paid income taxes at a higher rate on undistributed profits and be aware of the amount that would be refunded on the payment of future dividends to shareholders from consolidated retained earnings. In this case, that refundable amount is disclosed.

(e) If applicable, the entity also discloses that there are additional potential income tax consequences not practicably determinable. In the parent's separate financial statements, if any, the disclosure of the potential income tax consequences relates to the parent's retained earnings.

(f) An entity required to provide the disclosures referred above is also required to provide disclosures related to temporary differences associated with investments in subsidiaries, branches and associates or interests in joint ventures. In such cases, an entity considers this in determining the information to be disclosed under this requirement. For example, an entity ay be required to disclose the aggregate amount of temporary differences associated with investments in subsidiaries for which no deferred tax liabilities have been recognised. If it is impracticable to compute the amounts of unrecognised deferred tax liabilities, there may be amounts of potential income tax consequences of dividends not practicably determinable related to these subsidiaries.

1.8.14 Disclosure 14: Tax related contingencies

An entity discloses any tax-related contingent liabilities and contingent assets in accordance with Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*. Contingent liabilities and contingent assets may arise, for example, from unresolved disputes with the taxation authorities.

1.8.15 Disclosure 15: Change in tax rates or tax laws

Where changes in tax rates or tax laws are enacted or announced after the reporting period, an entity discloses any significant effect of those changes on its current and deferred tax assets and liabilities (see Ind AS 10, *Events after the Reporting Period*).

Illustration 1

An entity has a deductible temporary difference of ₹ 50,000. It has no taxable temporary differences against which it can be offset. The entity is also not anticipating any future profits. However, it can implement a tax planning strategy which can generate profits up to ₹ 60,000. The cost of *implementing this tax planning strategy is ₹12,000. The tax rate is 30%. Compute the deferred tax asset that should be recognised.*

Solution

The entity should recognise a deferred tax asset of ₹ 14,400 @ 30% of ₹ 48,000 (₹ 60,000 – ₹ 12,000).

The balance deferred tax asset of ₹ 600 @ 30% on ₹ 2,000 (₹ 50,000 – ₹ 48,000) shall remain unrecognised.

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Illustration 2

A Limited recognises interest income in its books on accrual basis. However, for income tax purposes the method is 'cash basis'. On December 31, 20X1, it has interest receivable of ₹10,000 and the tax rate was 25%. On 28th February, 20X1, the finance bill is introduced in the legislation that changes the tax rate to 30%. The finance bill is enacted as Act on 21st May, 20X2.

Discuss the treatment of deferred tax in case the reporting date of A Limited's financial statement is 31st December, 20X1 and these are approved for issued on 31st May, 20X2.

Solution

The difference of ₹ 10,000 between the carrying value of interest receivable of ₹ 10,000 and its tax base of NIL is a taxable temporary difference.

A Limited has to recognise a deferred tax liability of ₹ 2,500 (₹ 10,000 x 25%) in its financial statements for the reporting period ended on December 31, 20X1.

It will not recognise the deferred tax liability @ 30% because as on December 31, 20X1, this tax rate was neither substantively enacted or enacted on the reporting date. However, if the effect of this change is material, A Limited should disclose this difference in its financial statements.

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1.9 SIGNIFICANT CHANGES IN IND AS 12 VIS-À-VIS AS 22

S. No.	Particulars	Ind AS 12	AS 22
1.	*Approach for creating Deferred Tax*	Ind AS 12 is based on balance sheet approach. It requires recognition of tax consequences of differences between the carrying amounts	AS 22 is based on income statement approach. It requires recognition of tax consequences of differences between taxable income and accounting income. For this

		of assets and liabilities and their tax base.	purpose, differences between taxable income and accounting income are classified into permanent and timing differences.
2.	*Limited Exceptions for Recognition of Deferred Tax Asset*	As per Ind AS 12, subject to limited exceptions, deferred tax asset is recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised. The criteria for recognising deferred tax assets arising from the carry forward of unused tax losses and tax credits are the same that for recognising deferred tax assets arising from deductible temporary differences. However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity	As per AS 22, deferred tax assets are recognised and carried forward only to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realised. Where deferred tax asset is recognised against unabsorbed depreciation or carry forward of losses under tax laws, it is recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised.
3.	*Recognition of Current and Deferred Tax*	As per Ind AS 12, current and deferred tax are recognised as income or an expense and included in profit or loss for the period, except to the extent that	AS 22 does not specifically deal with this aspect.

		the tax arises from a transaction or event which is recognised outside profit or loss, either in other comprehensive income or directly in equity, in those cases tax is also recognised in other comprehensive income or in equity, as appropriate.	
4.	*Disclosure of DTA and DTL in Balance Sheet*	Ind AS 12 does not deal with this aspect except that it requires that income tax relating to each component of other comprehensive income shall be disclosed as current or non-current asset/liability in accordance with the requirements of Ind AS 1.	AS 22 deals with disclosure of deferred tax assets and deferred tax liabilities in the balance sheet.
5.	*Disclosure Requirements*	Disclosure requirements given in the Ind AS 12 are more detailed as compared to existing AS 22.	Less disclosure is required
6.	*DTA/DTL arising out of Revaluation of Assets*	Ind AS 12 requires that deferred tax asset/liability arising from revaluation of non-depreciable assets shall be measured on the basis of tax consequences from the sale of asset rather than through use.	AS 22 does not deal with this aspect.
7.	*Changes in Entities Tax Status or that of its Shareholders*	Ind AS 12 provides guidance as to how an entity should account for the tax consequences of a change in its tax status or that of its shareholders.	AS 22 does not deal with this aspect.
8.	*Virtual Certainty*	Since the concept of virtual certainty does not exist in Ind AS 12, this explanation is not included.	AS 22 explains virtual certainty supported by convincing evidence.
9.	*Guidance for Recognition of Deferred Tax in a Tax Holiday Period*	Ind AS 12 does not specifically deal with these situations.	AS 22 specifically provides guidance regarding recognition of deferred tax in the situations of Tax Holiday

			under Sections 80-IA and 80-IB and Tax Holiday under Sections 10A and 10B of the Income Tax Act, 1961. Similarly, AS 22 provides guidance regarding recognition of deferred tax asset in case of loss under the head 'capital gains'
10.	*Guidance on Certain Issues*	Ind AS 12 does not specifically deal with this aspect.	AS 22 specifically provides guidance regarding tax rates to be applied in measuring deferred tax assets/liabilities in a situation where a company pays tax under section 115JB.
11.	*Guidance on Uncertainty Over Income Tax Treatment*	Ind AS 12 gives special guidance on it.	AS 11 gives no such guidance.

TEST YOUR KNOWLEDGE

Questions

1. An asset which cost ₹ 150 has a carrying amount of ₹ 100. Cumulative depreciation for tax purposes is ₹ 90 and the tax rate is 25%. Calculate the tax base.

2. On 1st April 20X1, ABC Ltd acquired 100% shares of XYZ Ltd for ₹ 4,373 crore. By 31st March, 20X5, XYZ Ltd had made profits of ₹ 5 crore, which remain undistributed. Based on the tax legislation in India, the tax base investment in XYZ Ltd is its original cost. Assume the dividend distribution tax rate applicable is 15%.

3. ABC Ltd. acquired 50% of the shares in PQR Ltd. on 1st January, 20X1 for ₹ 1000 crore. By 31st March, 20X5 PQR Ltd. had made profits of ₹ 50 crore (ABC Ltd.'s share), which remained undistributed. Based on the tax legislation in India, the tax base of the investment in PQR Ltd. is its original cost. Assume the dividend distribution tax rate applicable is 15%.

4. A company had purchased an asset at ₹ 1,00,000. Estimated useful life of the asset is 5 years and depreciation rate is 20%. Depreciation rate for tax purposes is 25%. The operating profit is ₹ 1,00,000 for all the 5 years. Tax rate is 30% for the next 5 years. Calculate the Book Value as per financial and tax purposes and then DTL.

5. A Ltd. acquired B Ltd. The following assets and liabilities are acquired in a business combination:

₹ 000's

	Fair Value	Carrying amount	Temporary Difference
Plant and Equipment	250	260	(10)
Inventory	120	125	(5)
Debtors	200	210	(10)
	570	595	(25)
9% Debentures	(100)	(100)	
	470	495	
Consideration paid	500	500	
Goodwill	30	5	(25)

Calculate Deferred Tax Asset.

6. B Limited is a newly incorporated entity. Its first financial period ends on 31st March, 20X1. As on the said date, the following temporary differences exist:

   (a) Taxable temporary differences relating to accelerated depreciation of ₹ 9,000. These are expected to reverse equally over next 3 years.

   (b) Deductible temporary differences of ₹ 4,000 expected to reverse equally over next 4 years.

   It is expected that B Limited will continue to make losses for next 5 years. Tax rate is 30%. Losses can be carried forward but not backwards.

   Discuss the treatment of deferred tax as on 31st March, 20X1.

Answers

1. The tax base of the asset is ₹ 60 (cost of ₹ 150 less cumulative tax depreciation of ₹ 90). To recover the carrying amount of ₹ 100, the entity must earn taxable income of ₹ 100, but will only be able to deduct tax depreciation of ₹ 60. Consequently, the entity will pay income taxes of ₹ 10 (₹ 40 at 25%) when it recovers the carrying amount of the asset. The difference between the carrying amount of ₹ 100 and the tax base of ₹ 60 is a taxable temporary difference of ₹ 40. Therefore, the entity recognises a deferred tax liability of ₹ 10 (₹ 40 at 25%) representing the income taxes that it will pay when it recovers the carrying amount of the asset.

2. A taxable temporary difference of ₹ 5 therefore exists between the carrying value of the investment in XYZ at the reporting date of ₹ 4,378 (₹ 4,373 + ₹ 5) and its tax base of ₹ 4,373. Since a parent, by definition, controls a subsidiary, it will be able to control the reversal of this temporary difference, for example - through control of the dividend policy of the subsidiary. Therefore, deferred tax on such temporary difference is generally not provided unless it is probable that the temporary will reverse in the foreseeable future

3. A taxable temporary difference of ₹ 50 therefore exists between the carrying value of the investment in PQR at the reporting date of ₹ 1,050 (₹ 1,000 + ₹ 50) and its tax base of ₹ 1,000. As ABC Ltd. does not completely control PQR Ltd. it is not in a position to control the dividend policy of PQR Ltd. As a result, it cannot control the reversal of this temporary difference and deferred tax is provided on temporary differences arising on investments in joint venture. (50 x 15%).

4. Calculation of the Book Value as per financial and tax purposes.

Financial Accounting: **₹ 000's**

Year	1	2	3	4	5
Gross Block	100	100	100	100	100
Accumulated Depreciation	20	40	60	80	100
Carrying Amount	80	60	40	20	0

Tax Accounting: ₹ 000's

Year	1	2	3	4	5
Gross Block	100	100	100	100	100
Accumulated Depreciation	25	50	75	100	100
Carrying Amount	75	50	25	0	0

Calculation of DTL: ₹ 000's

Year	1	2	3	4	5
Carrying Amount	80	60	40	20	0
Tax Base	75	50	25	0	0
Difference	5	10	15	20	0
Deferred Tax Liability (Difference x 30%)	1.5	3	4.5	6	0

5. In this case there is a Deferred Tax Asset as the Tax base of assets acquired is higher by 25,000. DTA would be ₹ 7,500 (25,000 x 30%)

Journal entry:

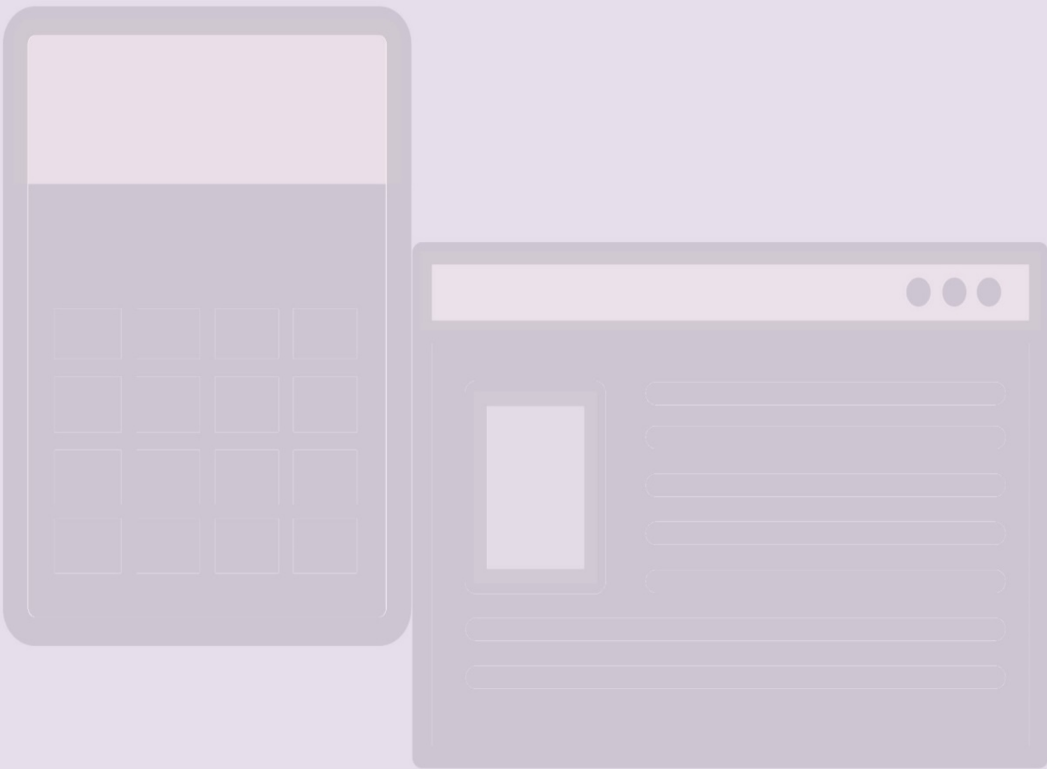
Plant and equipment	Dr	250	
Inventory	Dr	120	
Debtors	Dr	200	
Goodwill	Dr	22.5 (30- 7.5)	
DTA	Dr	7.5	
To 9% Debentures			100
To Bank			500

6. The year-wise anticipated reversal of temporary differences is as under:

Particulars	Year ending on 31st March, 20X2	Year ending on 31st March, 20X3	Year ending on 31st March, 20X4	Year ending on 31st March, 20X5
Reversal of taxable temporary difference relating to accelerated depreciation over next 3 years (₹ 9,000/3)	3,000	3,000	3,000	Nil
Reversal of deductible temporary difference relating to preliminary expenses over next 4 years (₹ 4,000/4)	1,000	1,000	1,000	1,000

B Limited will recognise a deferred tax liability of ₹ 2,700 on taxable temporary difference relating to accelerated depreciation of ₹ 9,000 @ 30%.

However, it will limit and recognise a deferred tax asset on reversal of deductible temporary difference relating to preliminary expenses reversing up to year ending 31st March, 20X4 amounting to ₹ 900 (₹ 3,000 @ 30%). No deferred tax asset shall be recognized for the reversal of deductible temporary difference for the year ending on 31st March, 20X5 as there are no taxable temporary differences. Further, the outlook is also a loss. However, if there are tax planning opportunities that could be identified for the year ending on 31st March, 20X5 deferred tax asset on the remainder of ₹ 1,000 (₹ 4,000 – ₹ 3,000) of deductible temporary difference could be recognised at the 30% tax rate.



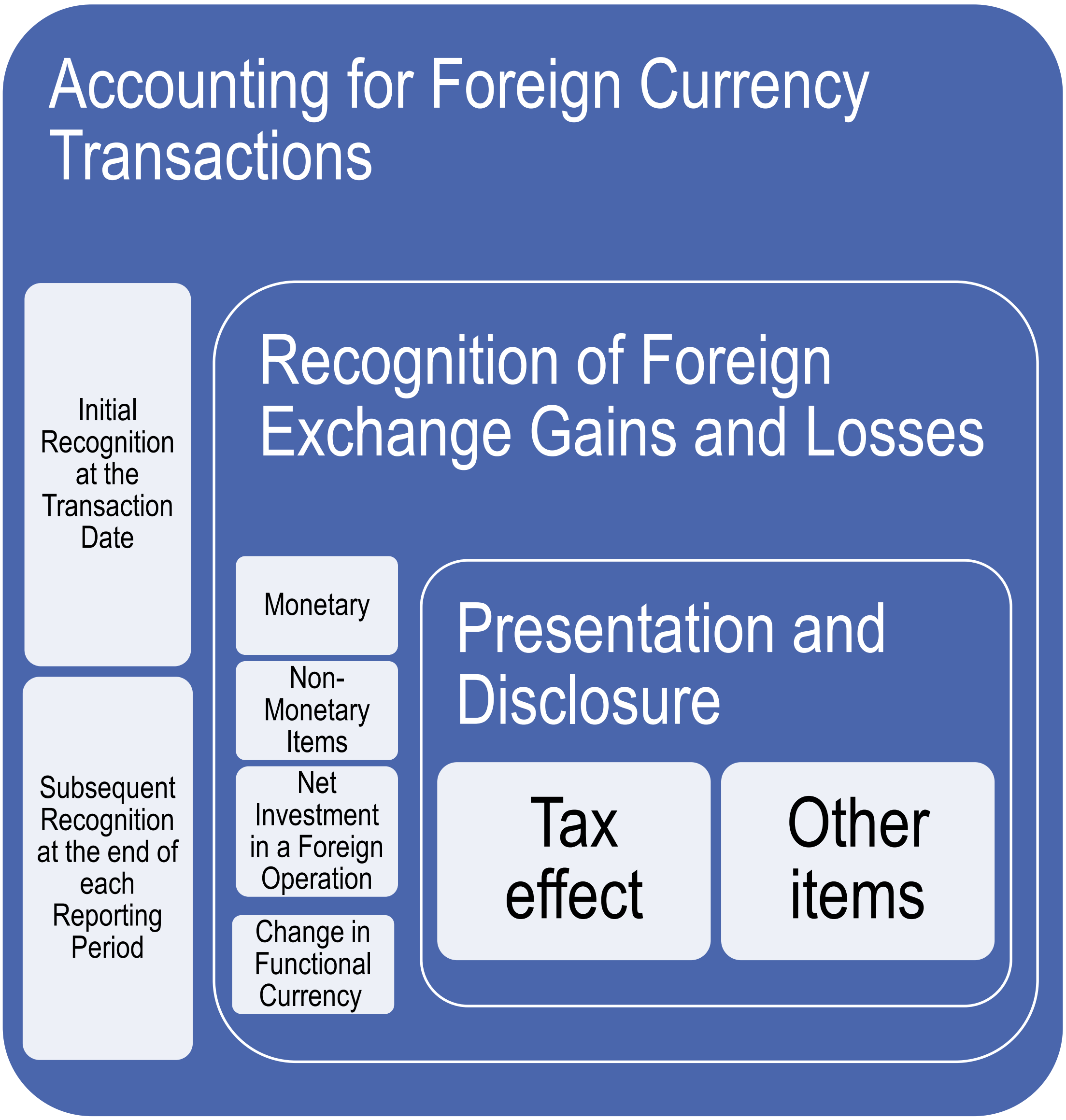
UNIT 2 : INDIAN ACCOUNTING STANDARD 21 : THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand the objective and scope of the standard
- Define the terms used in the standard like closing rate, exchange difference, exchange rate, fair value, foreign currency, foreign operation, functional currency, monetary items, group, net investment in a foreign operation, presentation currency and spot exchange rate.
- Report foreign currency transactions in the functional currency
- Report at the ends of subsequent reporting periods foreign currency monetary and non-monetary items
- Recognise exchange differences
- Apply the translation procedures in case of change in functional currency
- Use presentation currency and translate the items into it from the functional currency
- Incorporate the results and financial position of a foreign operation on translation.
- Apply the provisions of translation in case of consolidation.
- Deal with the disposal or partial disposal of a foreign operation
- Compute tax effects of all exchange differences
- Comply with the disclosure requirements given in the standard.

UNIT OVERVIEW



2.1 OBJECTIVE

The objective of the Standard is to address the accounting for foreign activities which include:

- transactions in foreign currencies; or
- foreign operations.

Considering that an entity may present its financial statements in a foreign currency, the Standard also seeks to prescribe how to translate financial statements into a presentation currency.

In this context, the Standard defines ***foreign currency*** as a currency other than the functional currency of the entity.

1. ***Functional currency*** is the currency of the primary economic environment in which the entity operates.

   In this regard, the primary economic environment will normally be the one in which it primarily generates and expends cash i.e. it operates. The functional currency is normally the currency of the country in which the entity is located. It might, however, be a different currency.

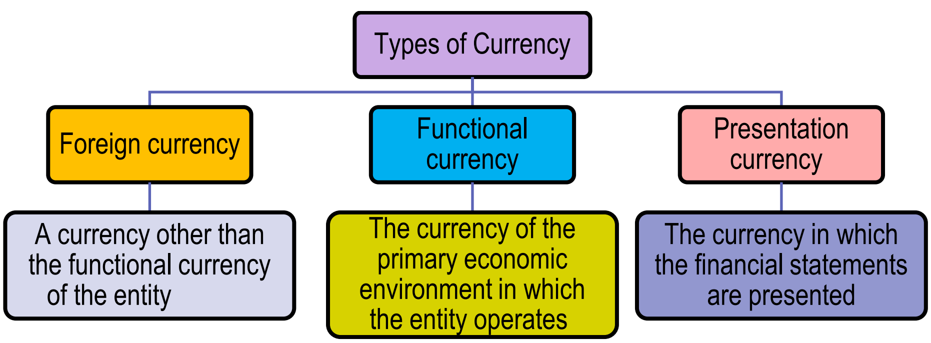
2. ***Foreign operation*** has been defined as an entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.

3. ***Presentation currency*** is the currency in which the financial statements are presented, the presentation currency may be different from the entity's functional currency.

4. **Spot exchange rate** is the exchange rate for immediate delivery.

5. **Closing rate** is the spot exchange rate at the end of the reporting period.

6. **Exchange difference** is the difference resulting from translating a given number of units of one currency into another currency at different exchange rates.is the exchange rate for immediate delivery.



2.2 SCOPE

- Ind AS 21 shall be applied:

  (a) in accounting for transactions and balances in foreign currencies, except for derivative transactions and balances covered by Ind AS 109.

  Foreign currency derivatives not covered by Ind AS 109 (e.g., some foreign currency derivatives that are embedded in other contracts) are within the scope of this Standard.

  The Standard also applies for translation of amounts relating to derivatives from functional currency to presentation currency.

  (b) in translating the results and financial position of foreign operations that are included in the financial statements of the entity by consolidation, proportionate consolidation or the equity method; and

  (c) in translating an entity's results and financial position into a presentation currency.

- Ind AS 21 **does not apply** to:

  (a) hedge accounting for foreign currency items, including the hedging of a net investment in a foreign operation; Ind AS 109 should be applied for hedge accounting;

  (b) presentation of cash flows from transactions in a foreign currency or to translations of cash flows of a foreign operation in the statement of cash flows (Refer Ind AS 7, Statement of Cash Flows); and

  (c) long term foreign currency items for which an entity has opted for the exemption as per Ind AS 101. Such an entity may continue to apply the accounting policy as opted for such long term foreign currency monetary items.

2.3 FUNCTIONAL CURRENCY

- An entity measures its assets, liabilities, equity, income and expenses in its functional currency.
- All transactions in currencies other than the functional currency are foreign currency transactions.

Ind AS 21 requires each entity to determine its functional currency.

- In determining its functional currency, an entity emphasises the currency that determines the pricing of the transactions that it undertakes, rather than focusing on the currency in which those transactions are denominated.

- The following are the factors that may be considered in determining an appropriate functional currency (**Primary indicators**):

  (a) the currency:

    i. that mainly influences sales prices for its goods and services. This will often be the currency in which sales prices are denominated and settled; and

    ii. of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.

  (b) the currency that mainly influences labour, material and other costs of providing goods and services. This will often be the currency in which these costs are denominated and settled.

- Other factors that may provide supporting evidence to determine an entity's functional currency are (**Secondary indicators**):

  (a) the currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated; and

  (b) the currency in which receipts from operating activities are usually retained.

- **If an entity is a foreign operation**, additional factors are set out in this Standard which should be considered to determine whether its functional currency is the same as that of the reporting entity of which it is a subsidiary, branch, associate or joint venture:

  (a) Whether the activities of foreign operations are carried out as an extension of that reporting entity, rather than being carried out with a significant degree of autonomy;

  > **An example of the former is when** the foreign operation only sells goods imported from the reporting entity and remits the proceeds to it.
  >
  > **An example of the latter** is when the foreign operations accumulates cash and other monetary items, incurs expenses, generates income and arranges borrowings, all substantially in its local currency.

  (b) Whether the transactions with the reporting entity are a high or a low proportion of the foreign operation's activities;

  (c) Whether cash flows from the activities of the foreign operations directly affect the cash flows of the reporting entity and are readily available for remittance to it.

  (d) Whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligation without funds being made available by the reporting entity.

  These factors also demonstrate whether the entity is integral to the reporting entity or not. In practice, the functional currency of a foreign operation that is integral to the parent / reporting entity will usually be the same as that of the parent / reporting entity.

- Determining an entity's functional currency depends on the facts and circumstances.

- When the above indicators are mixed and the functional currency is not obvious, the management will be required to use its judgment to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions. As part of this approach, management has to give priority to the primary indicators before considering the other indicators, which are designed to provide additional supporting evidence to determine an entity's functional currency.

Illustration 1

Future Ltd. sells a revitalising energy drink that is sold throughout the world. Sales of the energy drink comprise over 90% of the revenue of Future Ltd. For convenience and consistency in pricing, sales of the energy drink are denominated in USD. All financing activities of Future Ltd. are in its local currency (L$), although the company holds some USD cash reserves. Almost all of the costs incurred by Future Ltd. are denominated in L$. What is the functional currency of Future Ltd.?

Solution

The functional currency of Future Ltd. is L$ looking at the primary indicators. The facts presented indicate that the currency that mainly influences the cost of producing the energy drink is the L$. As stated in the fact pattern, pricing of the product in USD is done for convenience and consistency purposes; there is no indication that the sales price is influenced by the USD.

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Illustration 2

Small India Private Limited (Small), a subsidiary of Big Inc., takes orders from Indian customers for Big Inc's merchandise and then bills and collects for the sale of the merchandise in Rupees. Small also has a local warehouse in India to facilitate timely delivery and ensures that it remits to its parent all cash flows that it generates as the operations of Small are primarily financed by Big Inc. Big Inc is based out of US and has its functional currency as USD. What is Small's functional currency?

Solution

Small, although based in India with its cash flows generated in India, is essentially a "pass through company" established by its parent. Small is totally reliant on Big Inc. for financing and goods to be sold, despite the fact that goods are sold within India and in INR. Therefore, Small is not a self-contained entity in India, rather an entity that is dependent on its parent.

Due to this dependence of Small on its parent company, it can be said that the primary economic environment for Small is that of US and thus, its functional currency should also be USD.

Hence all the transactions of Small which are denominated in any currency other than USD should be recorded in USD at the spot rate and any changes in the exchange rate would result in an exchange gain or loss to be taken to the statement of profit or loss.

*****

Illustration 3

A is an Oman based company having a foreign operation, B, in India. The foreign operation was primarily set up to execute a construction project in India. The functional currency of A is OMR.

78% of entity B 's finances have been raised in USD by way of contribution from A. B's bank accounts are maintained in USD as well as INR. Cash flows generated by B are transferred to A on a monthly basis in USD in respect of repayment of finance received from A.

Revenues of B are in USD. Its competitors are globally based. Tendering for the construction project happened in USD.

B incurs 70% of the cost in INR and remaining 30% costs in USD.

Since B is located in India can it can presume its functional currency to be INR?

Solution

No, B cannot presume INR to be its functional currency on the basis of its location. It needs to consider various factors listed in Ind AS for determination of functional currency.

Primary indicators:

1. the currency that mainly influences
   (a) sales prices for its goods and services. This will often be the currency in which sales prices are denominated and settled; and of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.
   (b) labour, material and other costs of providing goods and services. This will often be the currency in which these costs are denominated and settled.
2. Other factors that may provide supporting evidence to determine an entity's functional currency are (**Secondary indicators**):
   (a) the currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated; and
   (b) the currency in which receipts from operating activities are usually retained.
3. **If an entity is a foreign operation**, additional factors set out in Ind AS 21 should be considered to determine whether its functional currency is the same as that of the reporting entity of which it is a subsidiary, branch, associate or joint venture:
   (a) Whether the activities of foreign operations are carried out as an extension of that reporting entity, rather than being carried out with a significant degree of autonomy;
   (b) Whether the transactions with the reporting entity are a high or a low proportion of the foreign operation's activities;
   (c) Whether cash flows from the activities of the foreign operations directly affect the cash flows of the reporting entity and are readily available for remittance to it.

(d) Whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligation without funds being made available by the reporting entity.

On the basis of additional factors mentioned in point 3 above, B cannot be said to have functional currency same as that of A Ltd.

Hence primary and secondary indicators should be used for the determination of functional currency of B giving priority to primary indicators. The analysis is given below:

- Its significant revenues and competitive forces are in USD.
- Its significant portion of cost is incurred in INR. Only 30% costs are in USD.
- 78% of its finances have been raised in USD.
- It retains its operating cash flows partially in USD and partially in INR.

Keeping these factors in view, USD should be considered as the functional currency of B.

Illustration 4

S Ltd is a company based out of India which got listed on Bombay Stock Exchange in the financial year ended 31st March, 20X1. Since then the company's operations have increased considerably. The company was engaged in the business of trading of motor cycles. The company only deals in imported Motor cycles. These motor cycles are imported from US.

After importing the motor cycles, these are sold across India through its various distribution channels. The company had only private customers earlier but the company also started corporate tie-up and increased its customer base to corporates also. The purchase of the motor cycles are in USD because the vendor(s) from whom these motor cycles are purchased those are all located in US.

All other operating expenses of the company are incurred in India only because of its location and they generally happen to be in INR

Currently, its customers are both corporate and private in the ratio of 70:30 approximately. The USD denominated prices of motor cycles in India are different from those in other countries.

The company is also expecting that in the coming years, its customers base will increase significantly in India and the current proportion may also change.

Currently, the invoices are raised to the corporate customers in USD for the purpose of hedging. However, private customers don't accept the same arrangement and hence invoices are raised to them in INR.

What would be the functional currency of this company?

Solution

The functional currency of S Ltd is INR.

Following factors need to be considered for determination of functional currency:

Primary indicators

1. the currency that mainly influences
   (a) sales prices for its goods and services. This will often be the currency in which sales prices are denominated and settled; and of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.
   (b) labour, material and other costs of providing goods and services. This will often be the currency in which these costs are denominated and settled.
2. Other factors that may provide supporting evidence to determine an entity's functional currency are (**Secondary indicators**):
   (a) the currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated; and
   (b) the currency in which receipts from operating activities are usually retained.

Primary and secondary indicators should be used for the determination of functional currency of S Ltd. giving priority to primary indicators.

The analysis is given below:

Ind AS 21 gives greater emphasis to the currency of the economy that determines the pricing of transactions, as opposed to the currency in which transactions are denominated.

Sales prices for motor cycles are mainly influenced by the competitive forces and regulations in India. The market for motor cycles depends on the economic situation in India and the company is in competition with importers of other motor cycle brands.

Even though 70% of the revenue of the company is denominated in USD, Indian economic conditions are the main factors affecting the prices. This is evidenced by the fact that USD denominated sales prices in India are different from USD denominated sales prices for the same motor cycles in other countries.

Management is able to determine the functional currency because the revenue is clearly influenced by the Indian economic environment and expenses are mixed.

On the basis of above analysis, INR should be considered as the functional currency of the company.

2.3.1 Currency of a Hyperinflationary Economy as a Functional Currency

An entity cannot adopt a functional currency other than that determined in accordance with this Standard.

If the functional currency of an entity is the currency of a hyperinflationary economy, it cannot avoid restatement in accordance with Ind AS 29 by selecting some other currency as its functional currency.

2.4 ACCOUNTING FOR FOREIGN CURRENCY TRANSACTIONS

2.4.1 Initial Recognition at the Transaction Date

- A foreign currency transaction is a transaction that is denominated or requires settlement in a foreign currency (i.e., a currency other than the functional currency of the entity), including transactions arising when an entity:

  (a) buys or sells goods or services whose price is denominated in a foreign currency;

  (b) borrows or lends funds with amounts denominated in a foreign currency; or

  (c) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

- A foreign currency transaction is initially recorded by translation in the entity's functional currency at the exchange rate on the transaction date.

  For practical reasons, a rate that approximates the actual exchange rate is often used.

  Example

  An average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period.

  However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate.

2.4.2 Monetary vs Non-Monetary Items

S. No.	Particulars	Monetary items	Non-monetary item
1.	Units of currency	Units of currency held and assets and liabilities to be received or paid are in a fixed or determinable number of units of currency.	There is no fixed or determinable number of units of currency

- **Examples of monetary items** include:
  - ♦ pensions and other employee benefits to be paid in cash;
  - ♦ provisions that are to be settled in cash;
  - ♦ lease liabilities;
  - ♦ cash dividends that are recognised as a liability;

- contract to receive (or deliver) a variable number of the entity's own equity instruments or a variable amount of assets in which the fair value* to be received (or delivered) equals a fixed or determinable number of units of currency.
- Most debt securities are considered as monetary items because their contractual cash flows are fixed or determinable.

Note: Fair value is the price that would be recovered to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

- **Examples of non-monetary items** include**:**
  - amounts prepaid for goods and services and income received in advance, on the basis that no money will be paid or received in the future;
  - goodwill;
  - intangible assets;
  - inventories;
  - property, plant and equipment;
  - right-of-use assets;
  - provisions that are to be settled by the delivery of a non-monetary asset.

2.4.3 Subsequent Recognition at the end of each Reporting Period

- At the reporting date, assets and liabilities denominated in a foreign currency are translated as follows:
  (a) **monetary items** are translated at the exchange rate at the reporting date i.e., closing rate;
  (b) **non-monetary items measured at historical cost** are not translated / restated; instead they remain at the exchange rate at the date of the transaction; and
  (c) **non-monetary items measured at fair value in a foreign currency** are translated at the exchange rate on the date the fair value was determined.
- The carrying amount of the item is determined applying the relevant Accounting Standard.

  For example, Property, plant and equipment may be measured at fair value or historical cost as per Ind AS 16, *Property, Plant and Equipment*.

  The carrying amount so determined, be it on the basis of historical cost or fair value, if in foreign currency, is translated into the functional currency in accordance with this Standard.
- In some cases, the carrying amount of items is determined by comparing two or more amounts e.g.:
  - Inventories - measured at lower of cost and net realisable value.

- ♦ Asset subject to impairment loss - lower of an asset's carrying amount and its recoverable amount.

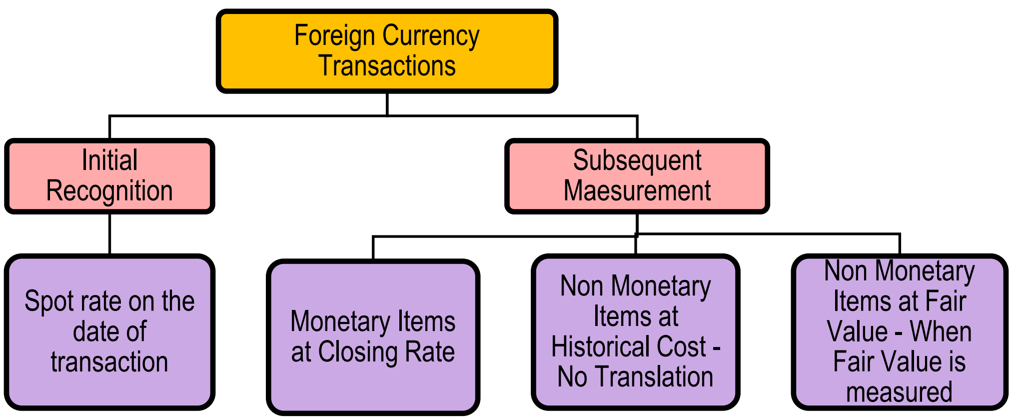
If such an asset is non-monetary and measured in a foreign currency, the carrying amount is determined by comparing:

(a) the cost or carrying amount, as appropriate, translated at the exchange rate at the date when that amount was determined (i.e. the rate at the date of the transaction for an item measured in terms of historical cost); and

(b) the net realisable value or recoverable amount, as appropriate, translated at the exchange rate at the date when that value was determined (eg. the closing rate at the end of the reporting period).

The above may result in an impairment loss being recognised in the functional currency but not in the foreign currency, or vice versa.

- Where a country has multiple exchange rates, the rate used is that at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date. If exchangeability between two currencies is temporarily lacking, the rate used is the first subsequent rate at which exchanges could be made.



2.4.4 Recognition of Foreign Exchange Gains and Losses

- Exchange difference is the difference resulting from translating a given number of units of one currency into another currency at different exchange rates.
- When the transaction occurs and settles within the same accounting period, all the exchange difference is recognized in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference is recognised in each period till settlement date based on change in exchange rates during each period.

2.4.4.1 Monetary Items

Exchange differences arising on the settlement of monetary items or on translating monetary items are recognised in profit or loss, except:

(i) for accounting of exchange difference as required by application of hedge accounting under Ind AS 109. For example - Ind AS 109 requires that exchange differences on monetary items that qualify as hedging instruments in a cash flow hedge should be recognised initially in other comprehensive income to the extent that the hedge is effective;

(ii) for monetary items that in substance form part of the reporting entity's net investment in a foreign operation (discussed below);

(iii) for long-term foreign currency monetary items in case the entity has exercised the option for recognising exchange differences on such items in equity (discussed below).

2.4.4.2 Non-Monetary Items

- Ind AS requires certain gains and losses to be recognised in other comprehensive income.

  For example, revaluation gain or loss on property, plant and equipment is recognised in other comprehensive income as per Ind AS 16. When such an asset is measured in a foreign currency and its revalued amount is translated as per this Standard using the rate at the date the fair value was determined, the resulting exchange gain or loss is also recognised in other comprehensive income.

- If the gain or loss on a non-monetary item is recognised in profit or loss, any exchange component of that gain or loss is also recognized in profit or loss.

2.4.4.3 Net Investment in a Foreign Operation

- **Net investment in a foreign operation** is the amount of the reporting entity's interest in the net assets of that operation.

- A monetary item receivable from or payable to a foreign operation may form part of the net investment in a foreign operation if the settlement of the monetary item is neither planned nor likely to occur in the foreseeable future.

  A loan to a foreign entity which is repayable on demand might seem to be a short-term item, rather than part of capital. However, if there is demonstrably no intent or expectation to demand repayment (eg, the short-term loan is getting rolled over continuously, whether or not the the foreign subsidiary is able to repay it), the loan has the same economic effect as that of a capital contribution.

  On the other hand, when there is a long-term loan with a fixed maturity period (say, 10 to 15 years) it does not automatically qualify to be treated as being part of the net investment simply because it is of a long duration, unless management has expressed its intention to renew the loan at maturity and accordingly, the period of repayment is not foreseeable.

It lies on the management to document its intention to renew by auditable evidence, such as board minutes. Otherwise, in the absence of management's intention to renew, the loan's maturity date implies that its settlement is planned in the foreseeable future.

- Such monetary items may include long-term receivables or loans but do not include trade receivables or trade payables.
- Exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation (i.e. a subsidiary, associate or joint venture) should be treated as follows:
  - ♦ Such exchange differences are recognised in profit or loss in the separate financial statements of the reporting entity and/or the individual financial statements of the foreign operation, as appropriate:
    - ❖ If such an item is denominated in the functional currency of the reporting entity, an exchange difference arises in the foreign operation's individual financial statements.
    - ❖ If such an item is denominated in the functional currency of the foreign operation, an exchange difference arises in the reporting entity's separate financial statements.
    - ❖ If such an item is denominated in a currency other than the functional currency of either the reporting entity or the foreign operation, an exchange difference arises in the reporting entity's separate financial statements and in the foreign operation's individual financial statements.
  - ♦ In the financial statements that include the foreign operation and the reporting entity (e.g., consolidated financial statements when the foreign operation is a subsidiary, associate or joint venture), such exchange differences are recognised initially in other comprehensive income and then reclassified from equity to profit or loss on disposal of the net investment.

Illustration 5

Functional currency of parent P is EURO while the functional currency of its subsidiary S is USD. P sells inventory to S and a transaction for the same was made for USD 300 during the year. At the year end, a balance of the same amount is outstanding as receivable from S. It has been observed that such balance amount has been continuing as receivable from S year on year and even though the payments in respect of these balances are expected to be received in the foreseeable future but if we look at the year-end then we see this balance as outstanding every year.

In addition to the trading balances between P and S, P has lent an amount of USD 500 to S that is not expected to be repaid in the foreseeable future. Should the exchange difference, if any, be recognised in the profit and loss?

Solution

The exchange gain or loss will arise in the books of accounts of P in respect of its trading balance with S and the same should be recognised in profit or loss. This being a balance for in the nature of trade receivable for P, it would not be considered as its net investment in a foreign operation (i.e. S).

The amount lent by P should be regarded as its net investment in S (i.e foreign operation). Thus, the exchange gain or loss incurred by P on the USD 500 loan should be recognised in profit or loss in P's separate financial statements and in other comprehensive income in its consolidated financial statements.

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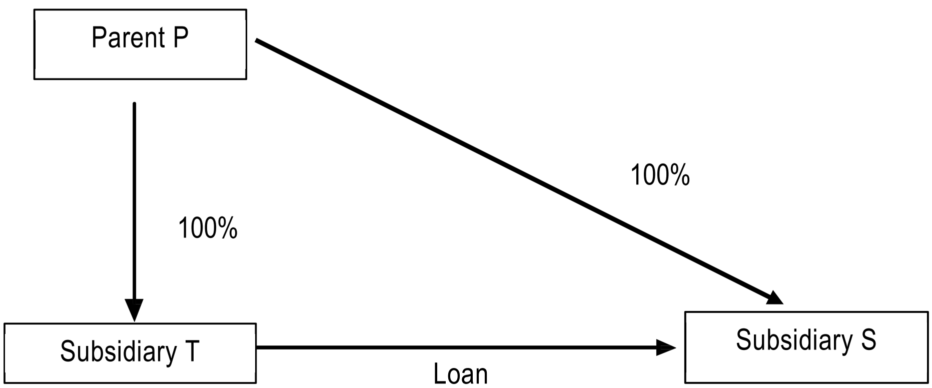
Illustration 6

Modifying the above illustration, suppose that for tax reasons, the 'permanent' funding (i.e. loan amount) extended to S is made via another entity in the group, T, rather than from P directly. That is, on the directions of P, T gives the loan to S. T is also a subsidiary of P. Where should the exchange difference, if any, be recognised?

Solution



Any exchange difference in respect of the loan is recognised in other comprehensive income in the consolidated financial statements because from the group's point of view the funding relates to an investment in a foreign operation. This is the case irrespective of the currency in which the loan is denominated. So if the loan is denominated in T's functional currency, and this is different from that of S, then exchange differences still should be recognised in other comprehensive income in the consolidated financial statements.

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2.4.5 Change in Functional Currency

- Once an entity has determined its functional currency, it is not changed unless there is a change in the relevant underlying transactions, events and conditions.

- If circumstances change and a change in functional currency is appropriate, then the change is accounted for prospectively from the date of the change.

For example, a change in the currency that mainly influences the sales price of goods and services may lead to a change in an entity's functional currency.

- For accounting the effect of a change in functional currency prospectively:
  - All items are translated into the new functional currency using the exchange rate at the date of the change. The resulting translated amounts for non-monetary items are treated as their historical cost.
  - Exchange differences arising from the translation of a foreign operation previously recognised in other comprehensive income are not reclassified from equity to profit or loss until the disposal of the operation.
  - Exchange gain or loss from long-term monetary items accumulated in equity (where such option is exercised) are not transferred to profit or loss immediately on change of the entity's functional currency; the balance would be transferred to profit or loss as per the manner provided by the option.
- Since entities prefer to present financial statements in their functional currency, a change in functional currency may be accompanied by a change in presentation currency. The choice of presentation currency represents an accounting policy, and any change should be applied retrospectively in accordance with Ind AS 8, unless impracticable. This means that the change should be treated as if the new presentation currency had always been the entity's presentation currency, with comparative amounts being restated into the new presentation currency.

2.5 USE OF A PRESENTATION CURRENCY OTHER THAN THE FUNCTIONAL CURRENCY

2.5.1 Translation to the Presentation Currency

- An entity measures items in its financial statements; but it may decide to present its financial statements in a currency or currencies other than its functional currency.

For example, an entity with INR functional currency may choose to present its financial statements in US Dollar because of its reporting requirement in US.

- There can be situations wherein a group comprises operations with a number of functional currencies. Under Ind AS 21, there is no concept of a "group" functional currency. Rather the group has a presentation currency only. Each entity in the group prepares financial statements in its own functional currency and translates these financial statements into the group's presentation currency (if different) for consolidation purposes.

- The results and financial position of an entity whose functional currency is not the currency of a hyperinflationary economy are translated into a different presentation currency as follows:

    (a) **assets and liabilities** for each balance sheet presented (i.e., including comparatives) are translated **at the closing rate** at the date of that balance sheet;

    (b) **income and expenses** are translated at exchange rates at the dates of relevant transactions; **average rates** for the period if often used if they are a reasonable approximation;

    (c) all **resulting exchange differences** should be **recognised in other comprehensive income** as they have little or no direct effect on the present and future cash flows from operations and are presented in a separate component of equity (generally referred to as the foreign currency translation reserve or currency translation adjustment) until disposal of the foreign operation;

    (d) cash flows are translated at exchange rates at the dates of the relevant transactions, although an appropriate average rate may be used.

- When the exchange differences relate to a foreign operation that is consolidated but not wholly-owned, accumulated exchange differences arising from translation and attributable to non-controlling interests are allocated to, and recognized as a part of, non-controlling interest in the consolidated balance sheet.

- The results and financial position of an entity whose functional currency is the currency of a hyperinflationary economy shall be translated into a different presentation currency as follows:

    (a) all amounts (i.e. assets, liabilities, equity items, income and expenses, including comparatives) shall be translated at the closing rate at the date of the most recent balance sheet, except that

    (b) when amounts are translated into the currency of a non-hyperinflationary economy, comparative amounts shall be those that were presented as current year amounts in the relevant prior year financial statements (ie not adjusted for subsequent changes in the price level or subsequent changes in exchange rates).

- When an entity's functional currency is the currency of a hyperinflationary economy, the entity shall restate its financial statements in accordance with Ind AS 29 before applying the translation method set out above, except for comparative amounts that are translated into a currency of a non-hyperinflationary economy.

2.5.2 Summary of the Approach in respect of Translation

The following is a summary of the approach under Ind AS 21 in respect of restatement/ translation:

- **Determine the functional currency of the entity** - each entity, whether a stand-alone entity, an entity with foreign operations (such as a parent) or a foreign operation (such as a subsidiary or branch) should determine its functional currency. Foreign currency transactions (i.e., transactions not in entity's functional currency) are translated into the entity's functional currency at the transaction date.

- A reporting entity may comprise branches, subsidiaries, associates or joint ventures.

  The functional currency of each entity should be determined separately which may or may not be the same as that of the reporting entity.

- **Translation of assets and liabilities denominated in foreign currency at the reporting date** - At the reporting date, assets and liabilities denominated in foreign currency are translated into functional currency as follows:

  — **Monetary items:** at the exchange rate at the reporting date i.e. closing rate.

  — **Non-monetary items measured at historical cost:** not translated/ restated.

  — **Non-monetary items measured at fair value:** at the exchange rate of the date of fair value.

- The Standard permits an entity to present its financial statements in any currency (or currencies). Accordingly, the financial statements of the parent, branches, subsidiaries, associates and joint ventures are required to be translated into the presentation currency of the Group (presentation currency of the parent entity) by any of the following two methods:

  Step by step method: Financial statements of foreign operations are translated into functional currency of any intermediate parent which is then translated into functional currency (or presentation currency, if different) of the ultimate parent.

  Direct method: Financial statements of the foreign operations are translated into functional currency (or presentation currency, if different) of the ultimate parent.

  Overall result is the presentation of the financial statements of the Group (i.e. the consolidated financial statements) in the functional currency (or presentation currency, if different) of the Group (parent entity).

2.6 TRANSLATION OF FOREIGN OPERATIONS

- The guidance provided on determining an entity's functional currency equally applies to determine the functional currency of a foreign operation of the entity.

- Effectively, the translation procedures those for translating foreign operations are the same as those followed when an entity presents its financial statements in a presentation currency that is different from its functional currency:

  (a) assets and liabilities are translated at the exchange rate at the reporting date;

  (b) items of income and expense are translated at exchange rates at the dates of the relevant transactions, although appropriate average rates may be used;

(c) the resulting exchange differences are recognised in other comprehensive income and are presented in a separate component of equity (generally referred to as the foreign currency translation reserve or currency translation adjustment) until disposal of the foreign operation; and

(d) cash flows are translated at exchange rates at the dates of the relevant transactions, although an appropriate average rate may be used.

- In addition to the exchange difference as stated above, the foreign currency translation reserve may include exchange differences arising from loans that form part of the parent's net investment in the foreign operation and gains and losses related to hedges of a net investment in a foreign operation.

2.7 DIFFERENCE IN THE REPORTING DATES

When there is difference in the year end of foreign operation and that of the reporting entity, the foreign operation often prepares additional statements as of the same date as the reporting entity's financial statements. When such financial statements are not prepared, Ind AS 110 allows the use of a different date provided that the difference is no greater than three months and adjustments are made for the effects of any significant transactions or other events that occur between the different dates. In such a case, the assets and liabilities of the foreign operation are translated at the exchange rate at the end of the reporting period of the foreign operation. Adjustments are made for significant changes in exchange rates up to the end of the reporting period of the reporting entity in accordance with Ind AS 110. A similar approach is used in applying the equity method to associates and joint ventures in accordance with Ind AS 28, *Investment in Associates and Joint Ventures.*

2.8 INTRA-GROUP TRANSACTIONS

- Although intra-group balances are eliminated on consolidation, any related foreign exchange gains or losses will not be eliminated. This is because the group has a real exposure to a foreign currency since one of the entities will need to obtain or sell foreign currency in order to settle the obligation or realise the proceeds received.
- Accordingly, in the consolidated financial statements of the reporting entity, the exchange difference arising on such intra group transactions is recognised in the statement of profit or loss account, unless it arises from a monetary item that forms part of a reporting entity's net investment in a foreign operation in which case it is taken to other comprehensive income.
- A Group may have intra-group transactions like sale and purchase of various assets such as property, plant and equipment, intangible assets or inventory. These transactions could result in intra-group profits or losses. At the time of consolidation, these profits / losses are eliminated

until the profit or loss is realized i.e. when the asset is sold outside the group, depreciated, amortised or written off as per the requirements of Ind AS 110. The elimination of intra-group profits / losses arising from such transactions, like sales between entities that are consolidated, should be based on the spot rate i.e. the exchange rate of the date of the sale.

Example

Parent P has USD as its functional currency and Subsidiary S has Euro as its functional currency. P, whose reporting date is 31st March, lends USD 100 to S on 30th September, 20X1. S converted the loan amount received into Euro on receipt.

	USD		EURO
Exchange rate at 30th September, 20X1	1	=	1.5
Exchange rate at 31st March, 20X2	1	=	2.0

Entries in the books of account of S

Date	Particulars		Debit (EURO)	Credit (EURO)
30th September, 20X1	Bank A/c	Dr.	150	
	To Intra-group payable			150
	(To recognize intra-group loan)			
31st March, 20X2	Exchange loss A/c	Dr.	50	
	To Intra-group payable			50
	(To recognize exchange loss on intra-group loan)			

In S's second entry, the liability is remeasured at 31st March, 20X2 and a translation loss is recorded.

Entries in the books of account of P

Date	Particulars		Debit (USD)	Credit (USD)
30th September,20X1	Intra group receivable	Dr.	100	
	To Cash			100
	(To recognize intra-group loan on issue)			

On consolidation at 31st March, 20X2, the receivable and payable (in respect of Intra-group receivable and payable) will be eliminated. However, an exchange loss equivalent to EURO 50 for the year ended 31st March, 20X2 will remain on consolidation. This is appropriate because S will need to obtain USD in order to repay the liability. Therefore, the group has a foreign currency exposure. The exchange loss will be taken to consolidated profit or loss, unless the loan forms part of P's net investment in S in which case it will be transferred to other comprehensive income at the time of consolidation.

Illustration 7

The functional and presentation currency of parent P is USD while the functional currency of its subsidiary S is EURO. P sold goods having a value of USD 100 to S when the exchange rate was USD 1 = Euro 2. At year-end, the amount is still due and the exchange rate is USD 1 = Euro 2.2. How should the exchange difference, if any, be accounted for in the consolidated financial statements?

Solution

At year-end, S should restate its accounts payable to EURO 220, recognising a loss of Euro 20 in its profit or loss. Thus, in the books of S, the balance payable to P will appear at EURO 220 while in the books of P the balance receivable from S will be USD 100.

For consolidation purposes, the assets and liabilities of S will be translated to USD at the closing rate.

At the time of consolidation, USD 100 which will get eliminated against the receivable in the books of P but the exchange loss of EURO 20 recorded in the subsidiary's statement of profit or loss has no equivalent gain in the parent's financial statements. Therefore, exchange loss of EURO 20 will remain in the consolidated statement of profit or loss.

The reason for this is that the intra-group balance represents a commitment to translate Euro into USD and this is similar to holding a foreign currency asset in the books of the parent company. i.e. the subsidiary would be required to buy USD to settle the obligation to the parent, so the Group has an exposure to foreign currency risk.

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Illustration 8

M Ltd is engaged in the business of manufacturing of bottles for pharmaceutical companies and non-pharmaceutical companies. It has a wholly owned subsidiary, G Ltd, which is engaged in the business of pharmaceuticals. G Ltd purchases the pharmaceutical bottles from its parent company. The demand of G Ltd is very high and the operations of M Ltd are very large and hence to cater to its shortfall, G Ltd also purchases the bottles from other companies. Purchases are made at the competitive prices.

M Ltd sold pharmaceuticals bottles to G Ltd for Euro 12 lacs on 1st February, 20X1. The cost of these bottles was ₹ 830 lacs in the books of M Ltd at the time of sale. At the year-end i.e. 31st March, 20X1, all these bottles were lying as closing stock with G Ltd. What should be the accounting treatment for the above?

Following additional information is available:

Exchange rate on 1st February, 20X1	*1 Euro = ₹ 83*
Exchange rate on 31st March, 20X1	*1 Euro = ₹ 85*

Solution

Accounting treatment in the books of M Ltd

M Ltd will recognize sales of ₹996 lacs (12 lacs Euro X 83)

Profit on sale of inventory = 996 lacs – 830 lacs = ₹166 lacs.

Accounting treatment in the books of G Ltd

G Ltd will recognize inventory on 1st February, 20X1 of Euro 12 lacs which will also be its closing stock at year end.

Accounting treatment in the consolidated financial statements

Receivable and payable in respect of above mentioned sale / purchase between M Ltd and G Ltd will get eliminated.

The closing stock of G Ltd will be translated at year end resulting in amount of closing stock of ₹1,020 lacs (12 lacs Euro X 85).

The restated amount of closing stock includes three components–

- Restated amount of cost of inventory for ₹850 lacs
- Profit element of ₹166 lacs; and
- Translated amount of profit element of ₹4 lacs.

At the time of consolidation, the two elements amounting to ₹170 lacs will be eliminated from the closing stock.

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2.9 GOODWILL AND FAIR VALUE ADJUSTMENTS ARISING FROM A BUSINESS COMBINATION

- Any goodwill and any fair value adjustments to the carrying amounts of assets and liabilities arising on a foreign operation's acquisition are treated as assets and liabilities of the foreign operation.
- Hence they are expressed in the functional currency of the foreign operation and should be translated at the closing exchange rate as is the case for other assets and liabilities.

2.10 DISPOSAL OR PARTIAL DISPOSAL OF FOREIGN OPERATIONS

2.10.1 Full Disposal

- A disposal may arise, for example, through sale, liquidation or repayment of share capital. On disposal of the foreign operation, the cumulative exchange differences relating to that foreign operation recognised in other comprehensive income and accumulated in equity are reclassified from equity to profit or loss (reclassification adjustment) when the gain or loss on disposal is recognised.

- On disposal of a subsidiary that includes a foreign operation, the cumulative amount of the exchange differences related to that foreign operation that have been attributed to the non-controlling interests is derecognised, but it is not reclassified to profit or loss.
- In addition to the disposal of an entity's entire interest in a foreign operation, the following partial disposals are accounted for as disposals:
  - ♦ when the partial disposal involves the loss of control of a subsidiary that includes a foreign operation, regardless of whether the entity retains a non-controlling interest (NCI) in its former subsidiary after the partial disposal; and
  - ♦ when the retained interest after the partial disposal of an interest in a joint arrangement or a partial disposal of an interest in an associate that includes a foreign operation is a financial asset that includes a foreign operation.

Example

Parent P owns 100 percent of foreign subsidiary S. P sells 70 percent of its investment and loses control of S. The entire balance in the foreign currency translation reserve in respect of S is reclassified to profit or loss.

2.10.2 Partial Disposal

A partial disposal of an entity's interest in a foreign operation is any reduction in an entity's ownership interest in a foreign operation, except for those reductions that are accounted for as disposals.

In the case of the partial disposal of a subsidiary that includes a foreign operation, the entity re-attributes the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income to the NCI in that foreign operation.

In any other partial disposal of a foreign operation, the entity reclassifies to profit or loss only the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income.

Example

Parent P owns 100 percent of foreign subsidiary S. P sells 10 percent of its investment and retains control over S. Therefore, 10 percent of the balance in the foreign currency translation reserve is reclassified to NCI.

Example

Parent P owns 35 percent of foreign associate B. P sells a 5 percent stake and retains significant influence over B. Therefore, one-seventh (5/35) of the balance in the foreign currency translation reserve is reclassified to profit or loss.

A write-down of the carrying amount of a foreign operation, either because of its own losses or because of an impairment recognised by the investor, does not constitute a partial disposal. Accordingly, no part of the foreign exchange gain or loss recognised in other comprehensive income is reclassified to profit or loss at the time of a write-down.

2.11 TAX EFFECT OF ALL EXCHANGE DIFFERENCES

Ind AS 12, Income Taxes, applies to tax effects of gains and losses on foreign currency transactions and exchange differences arising on translating the results and financial position of an entity (including a foreign operation) into a different currency.

2.12 DISCLOSURES

Ind AS 21 requires following disclosures:

(a) amount of exchange differences recognised in profit or loss except for those arising on financial instruments measured at fair value through profit or loss in accordance with Ind AS 109;

(b) net exchange differences recognised in other comprehensive income and accumulated in a separate component of equity, along with the reconciliation of the amount at the beginning and end of the period;

(c) when the presentation currency is different from the functional currency - that fact shall be stated, together with disclosure of the functional currency and the reason for using a different presentation currency;

(d) in case of change in functional currency of either the reporting entity or a significant foreign operation:

   (i) fact of such change;

   (ii) reason for the change and;

   (iii) date of change in functional currency;

(e) if presentation currency is different from functional currency, the financial statements can be described as complying with Ind AS only if all Ind AS including the translation method of this Standard is complied with.

   However, if an entity presents its financial statements or supplementary financial information in a currency other than its functional or presentation currency:

   (i) the information should be clearly identified as supplementary information to distinguish it from the information that complies with Ind AS;

   (ii) the currency in which the supplementary information is displayed should be disclosed; and

(iii) the entity's functional currency and the method of translation used to determine the supplementary information should be disclosed.

2.13 SIGNIFICANT DIFFERENCES IN IND AS 21 VIS-À-VIS AS 11

S. No.	Particulars	Ind AS 21	AS 11
1.	*Forward Exchange Contracts and other similar Financial Instruments*	Excludes from its scope forward exchange contracts and other similar financial instruments, which are treated in accordance with Ind AS 109.	Includes accounting for such contracts.
2.	*Exchange Differences arising on Translation of Certain Long-term Monetary Items from Foreign Currency to Functional Currency*	Ind AS 21 does not apply to long-term foreign currency monetary items recognised in the financial statements before the beginning of the first Ind AS financial reporting period as per the previous GAAP, i.e. AS 11. However, as provided in Ind AS 101, such an entity may continue to apply the accounting policy so opted for such long-term foreign currency monetary items as per the previous GAAP.	AS 11, gives an option to recognise exchange differences arising on translation of certain long-term monetary items from foreign currency to functional currency directly in equity, to be transferred to profit or loss over the life of the relevant liability/asset if such items are not related to acquisition of fixed assets. Where such items are related to acquisition of fixed assets, the foreign exchange differences can be recognised as part of the cost of the fixed assets.
3.	*Approach for Translation*	Ind AS 21 is based on the functional currency approach. However, in Ind AS 21, the factors to be considered in determining an entity's functional currency are similar to the indicators in AS 11 to determine the foreign operations as non-integral foreign operations.	AS 11 is based on integral foreign operations and non-integral foreign operations approach for accounting of a foreign operation.

		As a result, despite the difference in the term, there are no substantive differences in respect of accounting of a foreign operation.	
4.	*Presentation Currency*	As per Ind AS 21, presentation currency can be different from local currency and it gives detailed guidance in this regard.	AS 11 is silent on it.

TEST YOUR KNOWLEDGE

Questions

1. Parent P acquired 90 percent of subsidiary S some years ago. P now sells its entire investment in S for ₹ 1,500 lakhs. The net assets of S are 1,000 and the NCI in S is ₹ 100 lakhs. The cumulative exchange differences that have arisen during P's ownership are gains of ₹ 200 lakhs, resulting in P's foreign currency translation reserve in respect of S having a credit balance of ₹180 lakhs, while the cumulative amount of exchange differences that have been attributed to the NCI is ₹ 20 lakhs

   Calculate P's gain on disposal in its consolidated financial statements.

2. Entity A, whose functional currency is ₹, has a foreign operation, Entity B, with a Euro functional currency. Entity B issues to A perpetual debt (i.e. it has no maturity) denominated in euros with an annual interest rate of 6 per cent. The perpetual debt has no issuer call option or holder put option. Thus, contractually it is just an infinite stream of interest payments in Euros.

   In A's consolidated financial statements, can the perpetual debt be considered, in accordance with Ind AS 21.15, a monetary item "for which settlement is neither planned nor likely to occur in the foreseeable future" (i.e. part of A's net investment in B), with the exchange gains and losses on the perpetual debt therefore being recorded in equity?

3. Infotech Global Ltd. has a functional currency of USD and needs to translate its financial statements into the functional and presentation currency of Infotech Inc. (L$).

   The following balances appear in the books of of Infotech Global Ltd. at the year-end prior to translation:

	USD	L$
Property, plant and equipment	50,000	
Receivables	9,35,000	
Total assets	**9,85,000**	
Issued capital	50,000	30,055
Opening retained earnings	28,000	15,274
Profit & Loss A/c (Profit for the year)	20,000	
Accounts payable	8,40,000	
Accrued liabilities	47,000	
Total equity and liabilities	**9,85,000**	

   Translate the above balances of Infotech Global Ltd. into L$ ready for consolidation by Infotech Inc. (Share capital and opening retained earnings have been pre-populated.)

   Prepare a working of the cumulative balance of the foreign currency translation reserve.

Additional information:

Relevant exchange rates are:

Rate at beginning of the year L$ 1 = USD 1.22

Average rate for the year L$ 1 = USD 1.175

Rate at end of the year L$ 1 = USD 1.13

Answers

1. P's gain on disposal in its consolidated financial statements would be calculated in the following manner:

	(₹ in Lakhs)
Sale proceeds	1,500
Net assets of S	(1,000)
NCI derecognised	100
Foreign currency translation reserve	180
Gain on disposal	780

2. Yes, as per Ind AS 21 net investment in a foreign operation is the amount of the reporting entity's interest in the net assets of that operation.

As per para 15 of Ind AS 21, an entity may have a monetary item that is receivable from or payable to a foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, a part of the entity's net investment in that foreign operation. Such monetary items may include long-term receivables or loans. They do not include trade receivables or trade payables.

Analysis on the basis of above mentioned guidance

Through the origination of the perpetual debt, A has made a permanent investment in B. The interest payments are treated as interest receivable by A and interest payable by B, not as repayment of the principal debt. Hence, the fact that the interest payments are perpetual does not mean that settlement is planned or likely to occur. The perpetual debt can be considered part of A's net investment in B.

In accordance with para 15 of Ind AS 21, the foreign exchange gains and losses should be recorded in equity at the consolidated level because settlement of that perpetual debt is neither planned nor likely to occur.

3. **Translation of the balances for the purpose of consolidation**

	USD	Rate	L$
Property, plant and equipment	50,000	1.13	44,248
Receivables	9,35,000	1.13	8,27,434
Total assets	**9,85,000**		**8,71,682**
Issued capital	50,000	—	30,055
Opening retained earnings	28,000	—	15,274
Profit for the year	20,000	1.175	17,021
Accounts payable	8,40,000	1.13	7,43,363
Accrued liabilities	47,000	1.13	41,593
Total equity and liabilities USD	**9,85,000**		**8,47,306**
Foreign Currency Translation Reserve (Refer WN-1)			**24,376**
Total equity and liabilities L$			**8,71,682**

Working Note

1 **Cumulative balance of the FCTR**

Particulars	Actual translated amount in L$	Amount (Refer WN-2)	Difference
	A	B	B-A
Issued capital	30,055	44,248	14,193
Opening retained earnings	15,274	24,779	9,505
Profit for the year	17,021	17,699	678
	62,350	**86,726**	**24,376**

2 **Translated amount if the same conversion rate is applied to following items as applied on other items**

			Translated amount
Issued capital	50,000	1.13	44,248
Opening retained earnings	28,000	1.13	24,779
Profit for the year	20,000	1.13	17,699
	98,000		**86,726**

CHAPTER 11

IND AS ON DISCLOSURES IN THE FINANCIAL STATEMENTS

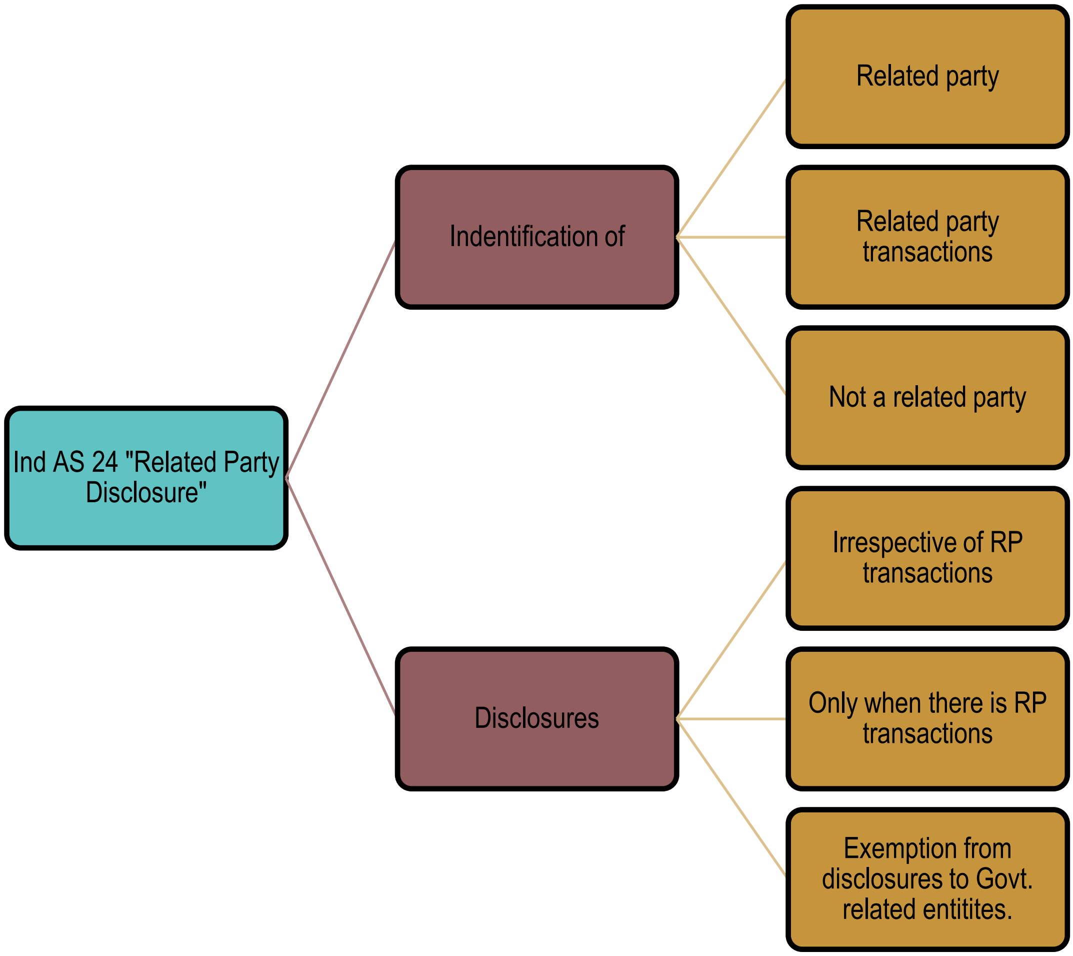
UNIT 1: INDIAN ACCOUNTING STANDARD 24: RELATED PARTY DISCLOSURES

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand the objective, scope and purpose of related party disclosures in the financial statements
- Define the terms related party, related party transactions, close members of the family of a person, key management personnel, government related entity and other related terms.
- Ensure the necessary disclosures to be made by an entity in its financial statements.
- Analyse the effect of such transactions in the financial position & profit or loss due to existence of such related parties.
- Appreciate the significant differences between Ind AS 24 and AS 18.

UNIT OVERVIEW



1.1 INTRODUCTION

An entity in the course of its commerce and business enters into numerous transactions and gets impacted by various related party relationships. It is a normal feature of business and commerce to have related party relationships. Entities frequently carry on their business activities through subsidiaries, joint ventures or associates. The entity has the ability to affect the financial and operating policy of a subsidiary as it has control over it. In the case of joint venture, it has joint control whereas in the case of an associate it has significant influence.

It is quite probable that related party relationship may have an effect on the profit or loss and financial position of an entity. The effect gets manifested through:

(a) Transactions that are entered between related parties may not be entered with unrelated parties;

- **Example :** An entity may sell goods to its parent at cost. It may not sell goods at cost to an unrelated party.

(b) Transactions with unrelated parties get influenced because of related party relationships.

- **Example :** S Limited, a subsidiary of H Limited, in steel manufacturing used to purchase billets from UR Limited. H Limited acquires 100% stake in FS Limited who also manufactures billets. FS Limited is now a fellow subsidiary of S Limited. H Limited instructs S Limited not to purchase billets from UR Limited but from FS Limited.

Therefore, the users of the financial statements of any entity should have:

(a) the knowledge of:

- related party relationships of an entity;
- entity's transactions, outstanding balances, commitments etc. with such related parties;

(b) as it may affect the user's assessments:

- of operations of the entity and
- the risks and opportunities facing the entity.

Examples

1. On instruction of H Ltd. (Holding Co.), S Ltd., a steel manufacturing company is buying billets from its follow subsidiary FS Ltd. though there are many other buyers offering better prices & incentives. Opportunity to buy at better & reasonable price is at risk since it may pass to other steel manufacturers in the same industry.
2. A subsidiary may be instructed by its parent not to engage in research & development.

1.2 OBJECTIVE

The objective of the Standard is to ensure that the financial statements of an entity contains necessary disclosures with respect to:

(a) related party relationships;

(b) related party transactions;

(c) outstanding balances with related parties; and

(d) commitments with related parties.

The disclosures are necessary so that users' attention could be drawn to the possibility that financial statements may be affected by such related party relationships and other items as mentioned above.

1.3 SCOPE

The Standard has to be applied in:

(a) identifying related party relationships;

(b) identifying related party transactions;

(c) identifying outstanding balances between an entity and its related parties;

(d) identifying commitments between an entity and its related parties;

(e) identifying the circumstances in which disclosures of above items is to be made; and

(f) determining the disclosures to be made about the above items.

The disclosures are to be made in:

(a) Individual financial statements of the entity.

(b) Consolidated and separate financial statements of a parent, venturer or an investor prepared in accordance with Ind AS 110 'Consolidated Financial Statements' or Ind AS 27, 'Separate Financial Statements'.

- Related party transactions and outstanding balances with other entities in a group are disclosed in an entity's financial statements, however, intra-group related party transactions and outstanding balances are eliminated in the preparation of consolidated financial statements of the group.

Exception:

If the above intra group related party transactions & outstanding balances are measured at fair value through profit or loss, then not eliminated.

- Disclosures not required when either
  - such disclosures are in conflict with the entity's duties of confidentiality in terms of a statute, regulator or similar competent authority governing the entity; or
  - the entity is prohibited by the statute, regulator or similar competent authority to disclose certain information otherwise required to be disclosed as per this Standard.

Example

Banks are obliged by law to maintain confidentiality in respect of their customers' transactions and this Standard would not override the obligation to preserve the confidentiality of customers' dealings.

1.4 DEFINITIONS

The following definitions are relevant for understanding the Standard:

1. A **related party** is (i) a person or (ii) entity that is related to the reporting entity.

2. A **reporting entity** in this Standard is an entity that is preparing its financial statements.

Thus two types of related party relationships are envisaged.

- One relationship is between the reporting entity and a person or persons.
- The other relationship is between the reporting entity and another entity or entities.

Note: The Standard clarifies that in considering each possible related party relationship, the attention should be directed to the substance of the relationship and not merely the legal form.

1.4.1 Understanding relationship between the reporting entity and a person(s)

3. A **person** or **a close member of that person's family is related to a reporting entity** if that person:

(a) has control or joint control over the reporting entity;

(b) has significant influence over the reporting entity; or

(c) is a member of the key management personnel of

- the reporting entity or
- a parent of the reporting entity.

4. **Close members of the family of a person** are the one who may be expected to influence or be influenced by that person in their dealings with the entity. It includes:

(a) that person's children, spouse or domestic partner, brother, sister, father and mother;

(b) children of that person's spouse or domestic partner; and

(c) dependents of that person or that person's spouse or domestic partner.

5. A **parent** is an entity that controls one or more subsidiaries to present consolidated financial statements.

Examples

1. Mr. A holds 51% in equity share capital of A Limited. A Limited has no other form of share capital. As Mr. A controls A Limited, he is a related party.
2. Mrs. A is wife of Mr. A. Mr. A holds 51% of equity shares of A Limited. A Limited has no other form of share capital. Mr. A controls A Limited. Since Mr. A is a related party, Mrs. A is also a related party of A Limited.
3. Mr. D is a director of A Limited. Being a member of key management personnel of A Limited, he is related to A Limited.
4. Mr. D is a director of H Limited. S Limited is a subsidiary of H Limited. Mr. D is related to S Limited.

1.4.2 Understanding relationship between the reporting entity and another entity/entities

6. An **entity is related to a reporting entity** if any of the following conditions applies:

(a) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).

Example

SA Limited and SB Limited are subsidiaries of H Limited. SA Limited, SB Limited and H Limited are related to each other.

(b) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).

Example

AS Limited is an associate of S Limited. S Limited is a subsidiary of H Limited. SH Limited is another subsidiary of H Limited. AS Limited and SH Limited are related parties.

(c) Both entities are joint ventures of the same third party.

Example

H Limited has entered into 2 joint ventures, JHA Limited (joint venture with A Limited) and JHB Limited (joint venture with B Limited). JHA Limited and JHB Limited are related parties.

(d) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.

Example

JH Limited is a joint venture of H Limited. AH limited is an associate of H Limited. JH Limited and AH Limited are related parties.

(e) The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.

(f) The entity is controlled or jointly controlled by a person identified above.

Example

Mr. A controls A Limited (the reporting entity). He also controls B Limited. A Limited and B Limited are related to each other.

(g) A person identified above has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

Example

Mr. A controls A Limited (the reporting entity). He is a non-executive director in B Limited. A Limited and B Limited are related parties.

(h) The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.

Example

A Ltd is a parent company with 3 subsidiary companies - B Ltd. C Ltd & D Ltd. It also has an associate company E Ltd. Subsidiary F Ltd of E Ltd provides key management personnel services to A Ltd. F Ltd. is in a related party relationship with A, B, C D & E Ltd.

The aforesaid definition is wide and exhaustive. It is quite possible that the identification of related parties may become an onerous task. The Standard therefore, as has been stated above, lays emphasis on the substance of the relationship rather than legal form. For example, there may be a special purpose entity in which the reporting entity may not have any ownership interest but where it may exercise control being the sole customer. This special purpose entity could fall in the definition of related party as envisaged by this Standard.

7. **Control** is the power over the investee when it is exposed or has rights to variable returns from its involvement with the investee and has the ability to affect those returns.

8. **Joint Control** is the contractually agreed sharing of control of an arrangement which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

9. **Significant influence** is the power to participate in the financial and operating policy decisions of the investee, but is not control of those policies.

The terms 'control', 'joint control' and 'significant influence' are discussed in detail in chapters on Ind AS 110, *Consolidated Financial Statements,* Ind AS 111 'J*oint Arrangements*' & Ind AS 28, *Investments in Associates & Joint Ventures.*

10. **Key management personnel** are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

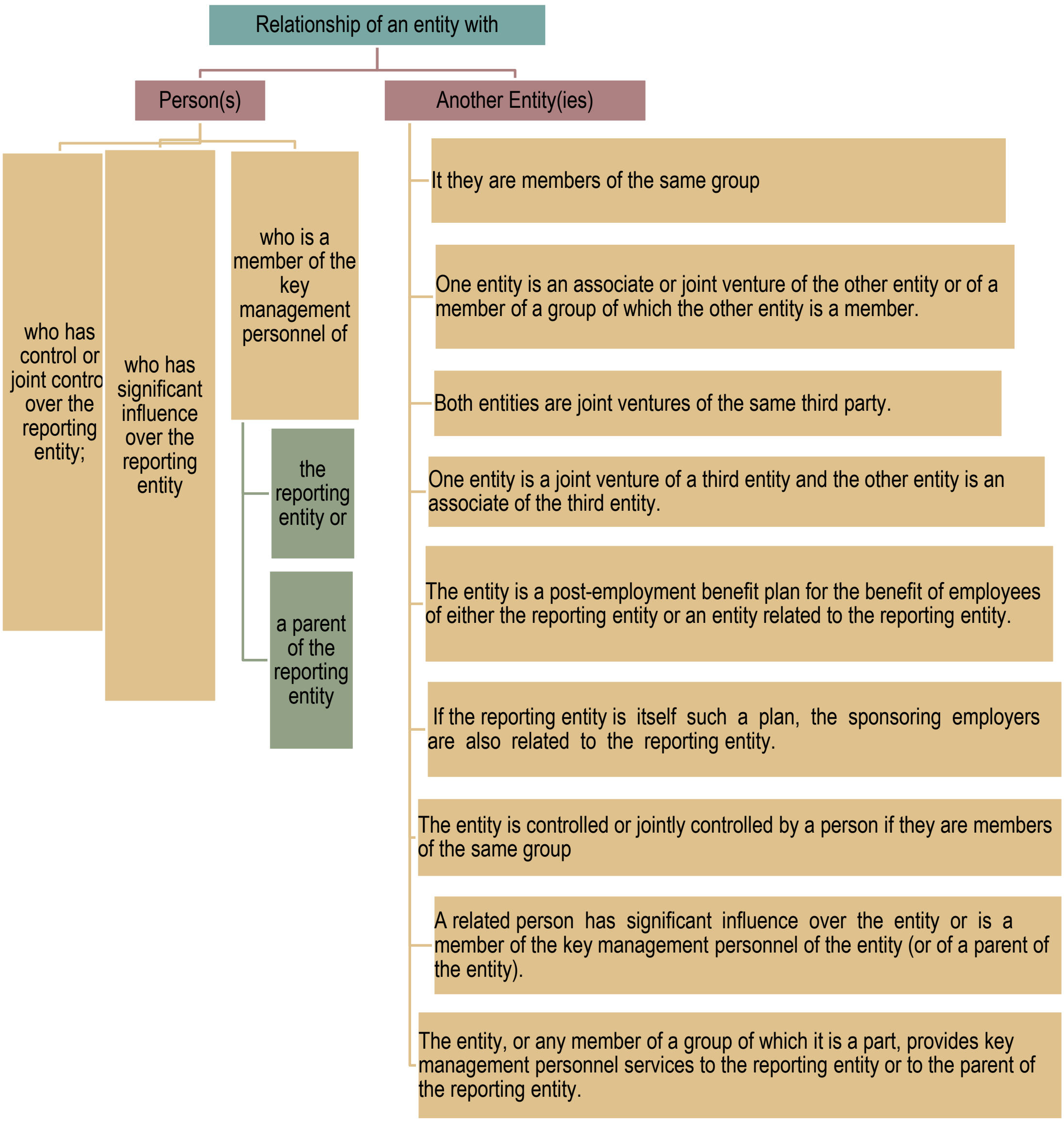
Analysis:

The definition includes executive as well as non-executive directors who have responsibility for the management and direction of a significant part of the business. It is not necessary that these people should have the 'director' designation. The term also includes members of the management committee(s), if those committee(s) have the authority for planning, directing and controlling the entity's activities.

The Standard further states that in the definition of a related party, an associate includes subsidiaries of the associate and a joint venture includes subsidiaries of the joint venture.

Example

R Limited has an associate B Limited. B Limited has a subsidiary S Limited, a joint venture J Limited and an associate A Limited. R Limited is the reporting entity. It identifies B Limited and S Limited as its related parties. J Limited and A Limited are not related parties of R Limited.



1.4.3 Understanding who are not related parties

The Standard clarifies that certain relationships are not related party relationships. These are as follows:

(a) Two entities are not related parties simply because they have a director or other member of key management personnel in common or because a member of key management personnel of one entity has significant influence over the other entity.

> **Example**
>
> Mr. A is a director in X Limited. He is also a director in Y Limited. He has no other interest in either of these companies. There are no transactions between these two entities. X Limited and Y Limited are not related parties.
>
> **Example**
>
> Mr. A is a director in X Limited. He is also a director in Y Limited. He has no other interest in either of these companies. Y Limited purchases the entire production of X Limited. The transactions are always at arm's length. X Limited and Y Limited may be related parties as it is quite possible that Y Limited may be able to exercise control/significant control over X Limited. As per this Standard substance is more important than mere legal form.

(b) Two venturers are not related parties simply because they share joint control over a joint venture.

> **Example**
>
> JV Limited is an equal joint venture of J Limited and V Limited. J Limited and V Limited are not related parties.

(c) (i) providers of finance, (ii) trade unions, (iii) public utilities, and (iv) departments and agencies of a government that does **not** control, jointly control or significantly influence the reporting entity, are not related parties simply by virtue of their normal dealings with an entity (even though they may affect the freedom of action of an entity or participate in its decision-making process).

> **Example**
>
> A Bank and B Bank has provided finance to XY Limited. By virtue of loan agreement, they occupy a non-executive observer seat on the Board of Directors of XY Limited. A Bank and B Bank are not related parties of XY Limited.

(d) a customer, supplier, franchisor, distributor or general agent with whom an entity transacts a significant volume of business, simply by virtue of the resulting economic dependence.

Example

A Limited is an auto ancillary of an automobile company. It supplies all its production to the automobile company. Automobile company has no other interest in A Limited. A Limited and automobile company are not related parties.

Not a related parties

- (a)Two entities are not related parties simply because they have a director or other member of key management personnel in common or because a member of key management personnel of one entity has significant influence over the other entity.
- (b)Two venturers are not related parties simply because they share joint control over a joint venture.
- (c)(i) providers of finance, (ii) trade unions, (iii) public utilities, and (iv) departments and agencies of a government that does **not** control, jointly control or significantly influence the reporting entity, are not related parties simply by virtue of their normal dealings with an entity (even though they may affect the freedom of action of an entity or participate in its decision-making process).
- (d)a customer, supplier, franchisor, distributor or general agent with whom an entity transacts a significant volume of business, simply by virtue of the resulting economic dependence.

1.4.4 Understanding related party transactions

11. A **related party transaction** is a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.

Examples

(a) purchases or sales of goods (finished or unfinished);

(b) purchases or sales of property and other assets;

(c) rendering or receiving of services;

(d) leases;

(e) transfers of research and development;

(f) transfers under licence agreements;

(g) transfers under finance arrangements (including loans and equity contributions in cash or in kind);

(h) provision of guarantees or collateral;

(i) commitments to do something if a particular event occurs or does not occur in the future, including executory contracts1 (recognised and unrecognised);

(j) settlement of liabilities on behalf of the entity or by the entity on behalf of that related party; and

(k) management contracts including for deputation of employees.

Note: It is not necessary for any consideration to be passed for related party transactions.

Also, participation by a parent or subsidiary in a defined benefit plan that shares risks between group entities is a transaction between related parties.

1.4.5 Other Important Definitions

12. **Compensation** includes all employee benefits (as defined in Ind AS 19, *Employee Benefits*) including employee benefits to which Ind AS 102, *Share-based Payments,* applies. Employee benefits are all forms of consideration paid, payable or provided by the entity, or on behalf of the entity, in exchange for services rendered to the entity. It also includes such consideration paid on behalf of a parent of the entity in respect of the entity. Compensation includes:

(a) short-term employee benefits, monetary such as wages, salaries and social security contributions, paid annual leave and paid sick leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non—monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

(b) post-employment benefits such as pensions, other retirement benefits, post-employment life insurance and post-employment medical care;

(c) other long-term employee benefits, including long service leave or sabbatical leave, jubilee or other long service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation;

(d) termination benefits; and

(e) share-based payment.

13. **Government** refers to government, government agencies and similar bodies whether local, national or international.

14. A **government-related entity** is an entity that is controlled, jointly controlled or significantly influenced by a government.

1.5 DISCLOSURES

The disclosure requirements can be broadly classified into two categories.

(a) Category 1 requires disclosures of relationships even though there are no related party transactions between the disclosed related parties.

(b) Category 2 requires disclosures of relationships and items only when there are related party transactions.

1.5.1 Disclosure- Relationships between parent and subsidiaries

The following disclosures of relationships, if exist, must be made irrespective of the fact whether there have been related party transactions by the entity:

- Under this an entity is required to disclose the name of its parent and, if different, the ultimate controlling party. It may be noted that the ultimate controlling party may be a person.

Example

S4 Limited (reporting entity) is a subsidiary of S3 Limited. S3 Limited is a subsidiary of S2 Limited. S2 Limited is a subsidiary of S1 Limited. S1 Limited is a subsidiary of H Limited. S4 Limited must disclose the name and relationship with S3 Limited and H Limited.

- If neither the entity's parent nor the ultimate controlling party produces consolidated financial statements available for public use, the name of the next most senior parent that does so shall also be disclosed.

Example

S4 Limited (reporting entity) is a subsidiary of S3 Limited. S3 Limited is a subsidiary of S2 Limited. S2 Limited is a subsidiary of S1 Limited. S1 Limited is a subsidiary of H Limited. Only S2 Limited and S1 Limited produces consolidated financial statements for public use. S4 Limited must disclose the name and relationship with S3 Limited, S2 Limited and H Limited.

Example

S4 Limited (reporting entity) is a subsidiary of S3 Limited. S3 Limited is a subsidiary of S2 Limited. S2 Limited is a subsidiary of S1 Limited. S1 Limited is a subsidiary of H Limited. S3 Limited, S2 Limited, S1 Limited and H Limited all produces consolidated financial statements for public use. S4 Limited must disclose the name and relationship with S3 Limited and H Limited.

- The disclosure of relationship between a parent and its subsidiary (reporting entity) is important because the existence of control relationship may prevent the reporting entity from being independent in making its financial and operating decisions. The disclosure of the name of the related party and the nature of the related party relationship where control exists may sometimes be at least as relevant in appraising an entity's prospects as are the operating results and the financial position presented in its financial statements. Such a related party may establish the entity's credit standing, determine the source and price of its raw materials, and determine to whom and at what price the product is sold.
- The Standard clarifies that the requirement to disclose related party relationships between a parent and its subsidiaries is in addition to the disclosure requirements in Ind AS 110, *Consolidated Financial Statements,* Ind AS 28, *Investments in Associates,* and *Joint Ventures*.

1.5.2 Category 2 Disclosure

Under this category, two types of disclosures are required. The first requires disclosures related to compensation to key management personnel. The second requires other disclosures where there have been related party transactions during the year.

1.5.2.1 Disclosures of compensation to key management personnel

An entity is required to disclose

(i) total compensation to key management personnel and

(ii) Compensation for each of the following categories:

   (a) short–term employee benefits;

   (b) post–employment benefits;

   (c) other long-term benefits;

   (d) termination benefits;

   (e) share–based payments.

If an entity obtains key management personnel services from another entity (the 'management entity'), the entity is not required to apply the requirements to the compensation paid or payable by the management entity to the management entity's employees or directors.

1.5.2.2 Disclosures where there have been related party transactions during the year

- Where an entity has had related party transactions during the periods covered by the financial statements, it shall disclose, in addition to disclosures listed above, the following for the users to understand the potential effect of these relationships and transactions on the financial statements:

   (a) the nature of the related party relationship;

(b) the information about these related party transactions and outstanding balances, including commitments.

- The disclosures, at a minimum, shall include:

  (a) the amount of the transactions;

  (b) the amount of outstanding balances, including commitments, and:

  - their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and
  - details of any guarantees given or received;

  (c) provisions for doubtful debts related to the amount of outstanding balances; and

  (d) the expense recognized during the period in respect of bad or doubtful debts due from related parties.

- Amounts incurred by the entity for the provision of key management personnel services that are provided by a separate management entity shall be disclosed.
- The aforesaid disclosures shall be made separately for each of the following categories:

  (a) the parent;

  (b) entities with joint control or significant influence over the entity;

  (c) subsidiaries;

  (d) associates;

  (e) joint ventures in which the entity is a joint venturer;

  (f) key management personnel of the entity or its parent; and

  (g) other related parties.

- The classification of amounts payable to, and receivable from, related parties in the different categories is an extension of the disclosure requirements in Ind AS 1, *Presentation of Financial Statements,* for information to be presented either in the balance sheet or in the notes. The categories are extended to provide a more comprehensive analysis of related party balances and apply to related party transactions.
- However, disclosures that related party transactions were made on terms equivalent to those that prevail in arm's length transactions should be made only if such terms can be substantiated.
- Items of a similar nature may be disclosed in aggregate except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the entity.

- Disclosure of details of particular transactions with individual related parties would frequently be too voluminous to be easily understood. Accordingly, items of a similar nature may be disclosed in aggregate by type of related party. However, this is not done in such a way as to obscure the importance of significant transactions.

Example

Hence, purchases or sales of goods are not aggregated with purchases or sales of fixed assets. Nor a material related party transaction with an individual party is clubbed in an aggregated disclosure.

1.6 EXEMPTION TO GOVERNMENT– RELATED ENTITIES

- A reporting entity is also exempt from the disclosure requirements in relation to (i) related party transactions (ii) outstanding balances and (iii) commitments with:
  - (a) a government that has control, joint control or significant influence over the reporting entity; and
  - (b) another entity that is a related party because the same government has control, joint – control or significant influence over both the reporting entity and the other entity.
- However, it shall disclose:
  - (a) the name of the government;
  - (b) the nature of the government's relationship with the entity (whether the government has control, joint control or significant influence over the entity);
  - (c) to enable the users of the entity's financial statements to understand the effect of related party transactions on its financial statements, the following information in sufficient details:
    - the nature and amount of each individually significant transaction;
    - for other transactions that are not significant individually but are significant when aggregated, either a qualitative or quantitative indication of their extent.
- Thus the reporting entity is expected to apply its judgment to determine the level of details it is required to disclose as per above. To enable the reporting entity to arrive at decision, it shall consider:
  - (a) the closeness of the related party relationship;
  - (b) whether the transaction is significant in size;
  - (c) whether the transaction is carried out on non-market terms;
  - (d) whether these are outside the normal day to day business operations;

(e) whether they are disclosed to regulatory or supervisory authorities;

(f) whether they are reported to senior management;

(g) whether they are subject to shareholder approval.

Disclosure requirements when exemption applies

In Entity A's financial statements, an example of disclosure to comply for **individually** significant transactions could be:

- **Example** of disclosure for individually significant transaction carried out on non-market terms

> On 15 January, 20X1 Entity A, a utility company in which Government G indirectly owns 75 per cent of outstanding shares, sold a 10-hectare piece of land to another government-related utility company for Rs. 5 million. On 31, December 20X0 a plot of land in a similar location, of a similar size and with similar characteristics, was sold for Rs. 3 million. There had not been any appreciation or depreciation of the land in the intervening period. See note X [of the financial statements] for disclosure of government assistance as required by Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance,* and notes Y and Z [of the financial statements] for compliance with other relevant Accounting Standards.

- **Example** of disclosure for individually significant transaction because of **size** of transaction

> In the year ended December 20X1 Government G provided Entity A, a utility company in which Government G indirectly owns 75 per cent of outstanding shares, with a loan equivalent to 50 percent of its funding requirement, repayable in quarterly instalments over the next five years. Interest is charged on the loan at a rate of 3 per cent, which is comparable to that charged on Entity A's bank loans.* See notes Y and Z [of the financial statements] for compliance with other relevant Accounting Standards.

- **Example** of disclosure of collectively significant transactions in Entity A's financial statements, an example of disclosure to comply with for **collectively** significant transactions could be:

> Government G, indirectly, owns 75 per cent of Entity A's outstanding shares. Entity A's significant transactions with Government G and other entities controlled, jointly controlled or significantly influenced by Government G are [a large portion of its sales of goods and purchases of raw materials] or [about 50 per cent of its sales of goods and about 35 per cent of its purchases of raw materials]. The company also benefits from guarantees by Government G of the company's bank borrowing. See note X [of the financial statements] for disclosure of government assistance as required by Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance,* and notes Y and Z [of the financial statements] for compliance with other relevant Accounting Standards.

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* If the reporting entity had concluded that this transaction constituted government assistance it would have needed to consider the disclosure in Ind AS 20.

1.7 SIGNIFICANT DIFFERENCES IN IND AS 24 VIS-A-VIS AS 18

S. No.	Particulars	Ind AS 24	AS 18
1.	*Definition of Relative*	Ind AS 24 uses the term "a close member of the family of a person".	AS 18 uses the term "relatives of an individual"
		Definition of close members of family as per Ind AS 24 includes those family members, who may be expected to influence, or be influenced by, that person in their dealings with the entity, including: (a) that person's children, spouse or domestic partner, brother, sister, father and mother; (b) children of that person's spouse or domestic partner; and (c) dependents of that person or that person's spouse or domestic partner. Hence, the definition as per Ind AS 24 is much wider.	AS 18 covers the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by, that individual in his/her dealings with the reporting enterprise.
2.	*State Controlled Enterprise:*	Ind AS 24, there is extended coverage of Government Enterprises, as it defines a government-related entity as "an entity that is controlled, jointly controlled or significantly influenced by a government." Further, "Government refers to government, government agencies and similar bodies whether local, national or international."	AS 18 defines state-controlled enterprise as *"an enterprise which is under the control of the Central Government and/or any State Government(s)"*.
3.	*Key Management Personnel*	Ind AS 24 covers KMP of the parent as well. Ind AS 24 also covers the entity, or any member of a group of which it is a part, providing key management personnel services to the	AS 18 covers key management personnel (KMP) of the entity only

S. No.	Particulars	Ind AS 24	AS 18
		reporting entity or to the parent of the reporting entity	
4.	*Related Parties in case of Joint Venture*	Under Ind AS 24 there is extended coverage in case of joint ventures. Two entities are related to each other in both their financial statements, if they are either co-venturers or one is a venturer and the other is an associate.	As per AS 18, co-venturers or co-associates are not related to each other
5.	*Effect of influences which do not lead to transactions*	Ind AS 24 does not specifically mention this.	AS 18 mentions that where there is an inherent difficulty for management to determine the effect of influences which do not lead to transactions, disclosure of such effects is not required
6.	*Post-employment Benefits*	Ind AS 24 specifically includes post-employment benefit plans for the benefit of employees of an entity or its related entity as related parties.	AS 18 does not specifically cover entities that are post-employment benefit plans, as related parties.
7.	*Next Most Senior Parent*	Ind AS 24 requires an additional disclosure as to the name of the next most senior parent which produces consolidated financial statements for public use.	AS 18 has no such requirement.
8.	*Disclosure for Compensation*	Ind AS 24 requires extended disclosures for compensation of KMP under different categories.	AS 18 does not specifically require
9.	*Disclosure of 'Amount of the Transactions' vs 'Volume of the Transactions*	Ind AS 24 requires "the amount of the transactions" need to be disclosed.	AS 18 gives an option to disclose the "Volume of the transactions either as an amount or as an appropriate proportion".
10.	*Government Related Entities:*	Ind AS 24 requires disclosures of certain information by the government related entities.	AS 18 presently exempts the disclosure of such information.
11.	*Clarification of Control,*	Ind AS 24 neither defines these terms nor it includes such	AS 18 includes definition and clarificatory text,

S. No.	Particulars	Ind AS 24	AS 18
	Substantial Interest and Significant Influence	clarificatory text and allows respective standards to deal with the same.	primarily with regard to control, substantial interest (including 20% threshold), significant influence (including 20% threshold)

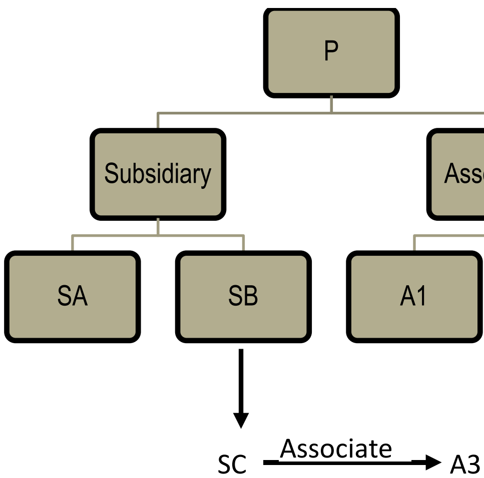
Note: It is strongly advised to draw the diagrams of related party relationships for the following illustrations to test their understanding of the subject matter)

Illustration 1 (Associates and subsidiaries)

Entity P Limited has a controlling interest in subsidiaries SA Limited and SB Limited and SC Limited. SC Limited is a subsidiary of SB Limited. P Limited also has significant influence over associates A1 Limited and A2 Limited. Subsidiary SC Limited has significant influence over associate A3 Limited

Examine related party relationships of various entities.

Solution



- In Separate Financial Statements of P Limited, SA Limited, SB Limited, SC Limited, A1 Limited, A2 Limited and A3 Limited are all related parties.
- In the Individual Financial Statements of SA Limited, P Limited, SB Limited, SC Limited, A1 Limited, A2 Limited and A3 Limited are all related parties.
- In the Individual Financial Statements of SB Limited, P Limited, SA Limited, SC Limited, A1 Limited, A2 Limited and A3 Limited are all related parties.
- In the Individual Financial Statements of SC Limited, P Limited, SA Limited, SB Limited, A1 Limited, A2 Limited and A3 Limited are all related parties.

- In the Individual Financial Statements of associates A1 Limited, A2 Limited and A3 Limited; P Limited, SA Limited, SB Limited and SC Limited are related parties.
- A1 Limited, A2 Limited and A3 Limited are not related to each other.
- In Consolidated Financial Statements of P Limited, A1 Limited, A2 Limited and A3 Limited are not part of the Group since Group includes only parent and subsidiaries.

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Illustration 2 (key management personnel)

Mr. X has a 100% investment in A Limited. He is also a member of the key management personnel (KMP) of C Limited. B Limited has a 100% investment in C Limited.

Required

(a) Examine related party relationships from the perspective of C Limited for A Limited.

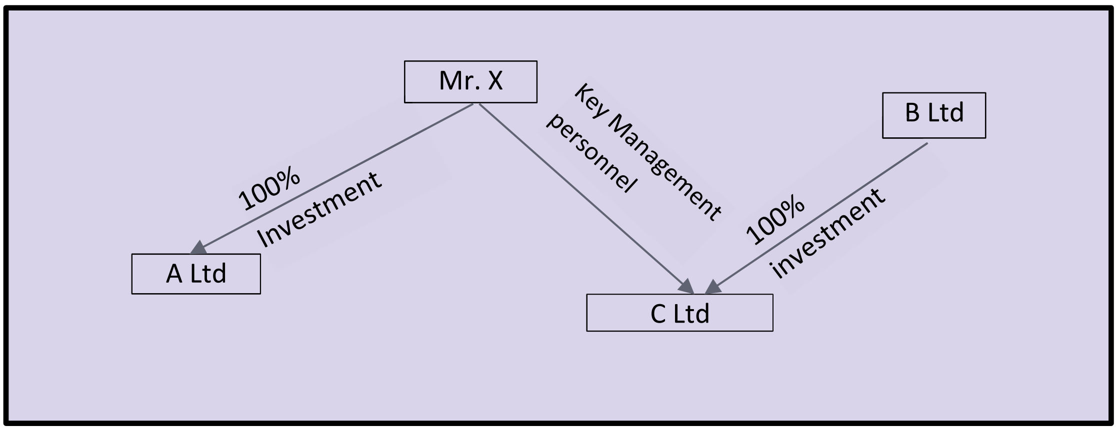
(b) Examine related party relationships from the perspective of C Limited for A Limited if Mr. X is a KMP of B Limited and not C Limited.

(c) Will the outcome in (a) & (b) would be different if Mr. X has joint control over A Limited.

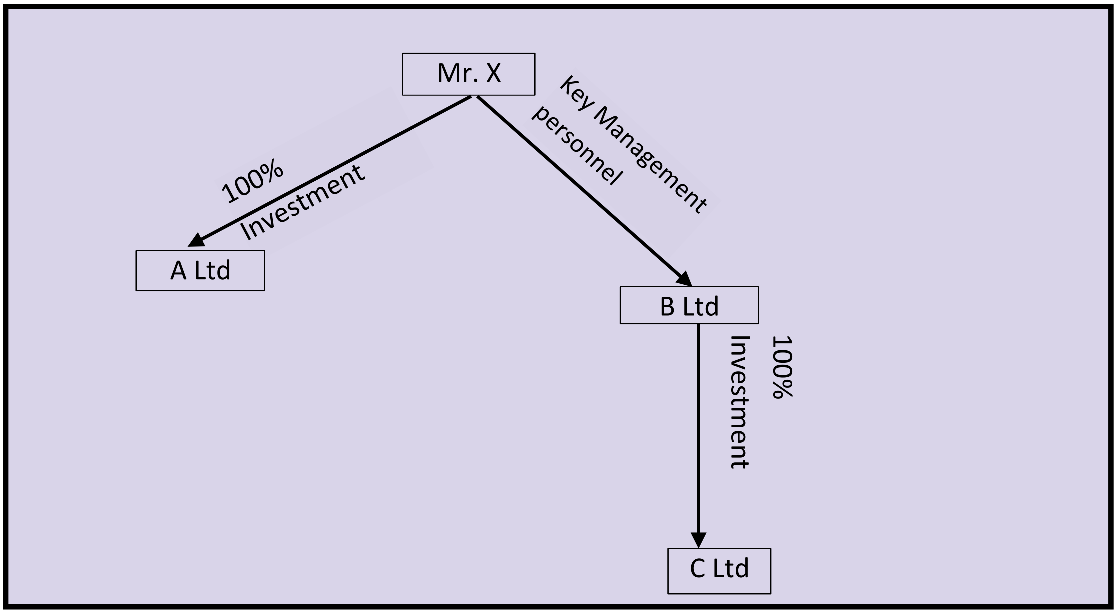
(d) Will the outcome in (a) & (b) would be different if Mr. X has significant influence over A Limited.

Solution

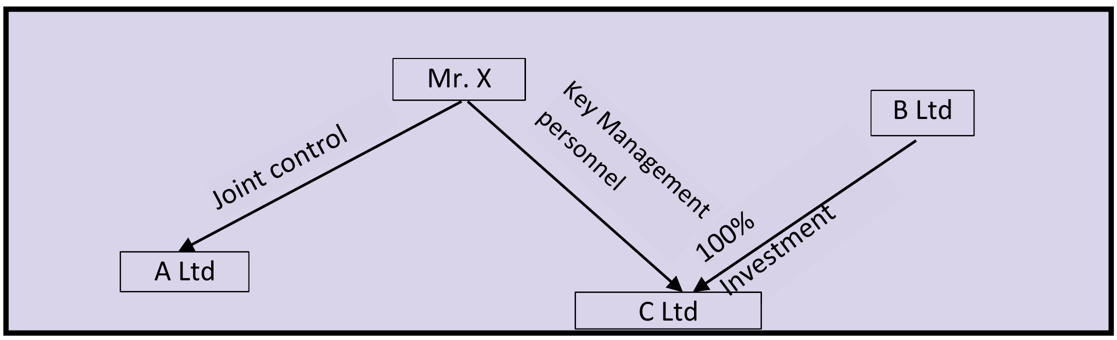
(a) A Limited is related to C Limited because Mr. X controls A Limited and is a member of KMP of C Limited.



(b) Still A Limited will be related to C Limited.



(c) No, Still A Limited will be related to C Limited.



(d) Yes, A Ltd. is not controlled by Mr. X. Therefore, despite Mr. X being KMP of C Ltd., A Ltd., having significant influence of Mr. X, will not be considered as related party of C Limited.

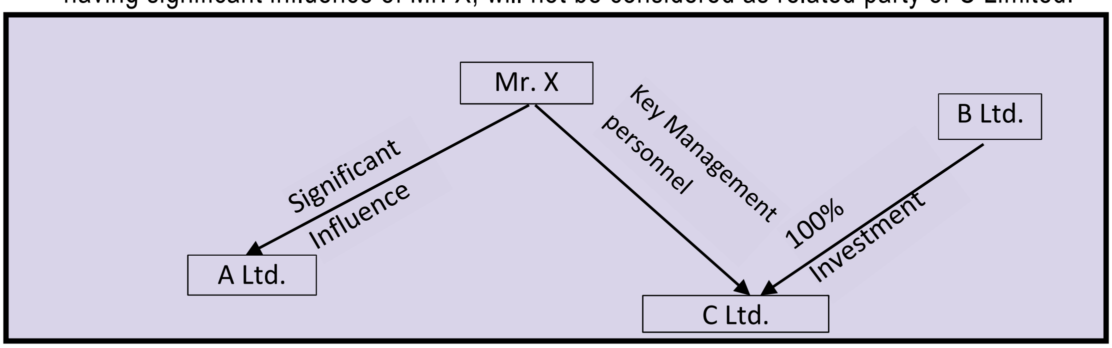


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Illustration 3 (person as investor)

Mr. X has an investment in A Limited and B Limited.

Required

(i) Examine when can related party relationship be established

(a) from the perspective of A Limited's financial statements:

(b) from the perspective of B Limited's financial statements:

(ii) Will A Limited and B Limited be related parties if Mr. X has only significant influence over both A Limited and B Limited

Solution

(i) (a) If Mr. X controls or jointly controls A Limited, B Limited is related to A Limited when Mr. X has control, joint control or significant influence over Entity B.

(b) If Mr. X controls or jointly controls A Limited, A Limited is related to Entity B when Mr. X has control, joint control or significant influence over Entity B.

(ii) No, A Ltd. & B Ltd., will not be considered as related party since no direct or indirect control is exercised on each other in any of the manner.

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Illustration 4 (Partial exemption for government related entities):

Government G directly controls Entity 1 and Entity 2. It indirectly controls Entity A and Entity B through Entity 1, and Entity C and Entity D through Entity 2. Person X is a member of the key management personnel in Entity 1.

Examine the entity to whom the exemption for disclosure to be given and for transaction with whom.

Solution

For Entity A's financial statements, the exemption of Ind AS 24 applies to:

(a) transactions with Government G; and

(b) transactions with Entities 1 and 2 and Entities B, C and D. However, that exemption does not apply to transactions with Person X.

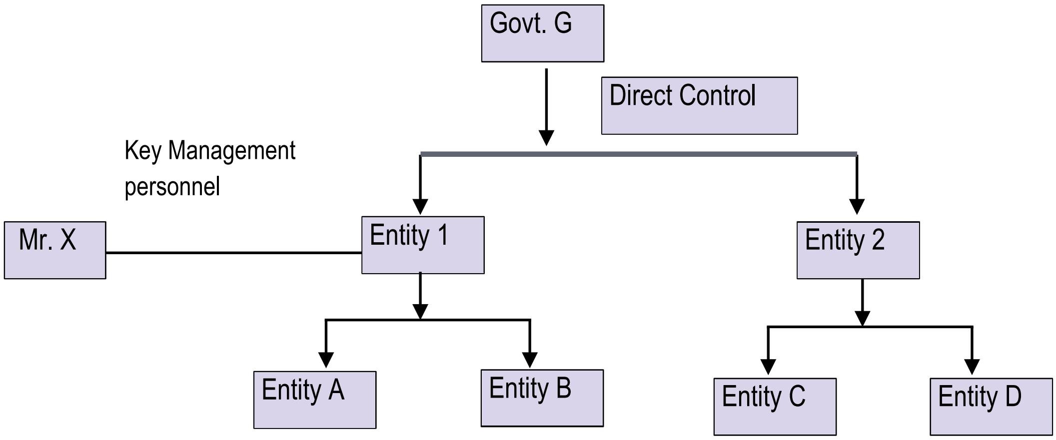

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Illustration 5

Power Limited is a producer of electricity. Transmission Limited regularly purchases electricity from Power Limited. Power Limited whose financial year ends on March 31, 20X2, acquired 100% shareholding of Transmission Limited on July 15, 20X1. However, the entire shareholding is disposed of on March 21, 20X2. Power Limited and Transmission Limited had transactions when Transmission Limited was a subsidiary of Power Limited and also in the period when it was not a subsidiary of Power Limited.

For which period, related party disclosure should Power Limited make in its financial statements for the year ended March 31, 20X2 with respect to transactions with Transmission Limited.

Solution

Power Limited should in its financial statements for the year ended March 31, 20X2 make related party disclosures for the period from July 15, 20X1 to March 21, 20X2 when Transmission Limited was its subsidiary.

*****

TEST YOUR KNOWLEDGE

Questions

1. Mr. X is a domestic partner of Ms. Y. Mr. X has an investment in A Limited and Ms. Y has an investment in B Limited.

   Required

   (a) Examine when can a related party relationship is established, from the perspective of A Limited's financial statements:

   (b) Examine when can related party relationship is established, from the perspective of B Limited's financial statements:

   (c) Will A Limited and B Limited be related parties if Mr. X has only significant influence over A Limited and Ms. Y also has significant influence over B Limited:

2. A Limited has both (i) joint control over B Limited and (ii) joint control or significant influence over C Limited

   Required

   (a) Examine related party relationship from the perspective of C Limited's financial statements.

   (b) Examine related party relationship from the perspective of B Limited's financial statements.

3. ABC Ltd. is a long-standing customer of XYZ Ltd. Mrs. P whose husband is a director in XYZ Ltd. purchased a controlling interest in entity ABC Ltd. on 1st June, 20X1. Sales of products from XYZ Ltd. to ABC Ltd. in the two-month period from 1st April 20X1 to 31st May 20X1 totalled Rs. 8,00,000. Following the share purchase by Mrs. P, XYZ Ltd. began to supply the products at a discount of 20% to their normal selling price and allowed ABC Ltd. three months' credit (previously ABC Ltd. was only allowed one month's credit, XYZ Ltd.'s normal credit policy). Sales of products from XYZ Ltd. to ABC Ltd. in the ten-month period from 1st June 20X1 to 31st March 20X1 totalled Rs. 60,00,000. On 31st March 20X2, the trade receivables of XYZ Ltd. included Rs. 18,00,000 in respect of amounts owing by ABC Ltd.

   Analyse and show (where possible by quantifying amounts) how the above event would be reported in the financial statements of XYZ Ltd. for the year ended 31st March 20X2 as per Ind AS. You are required to mention the disclosure requirements as well.

4. Mr. Atul is an independent director of a company X Ltd. He plays a vital role in the Management of X Ltd. and contributes in major decision making process of the organisation. X Ltd. pays sitting fee of ₹ 2,00,000 to him for every Board of Directors' (BOD) meeting he attends. Throughout the year, X Ltd. had 5 such meetings which was attended by Mr. Atul.

   Similarly, a non-executive director, Mr. Naveen also attended 5 BOD meetings and charged ₹ 1,50,000 per meeting. The Accountant of X Ltd. believes that they being not the employees of the organisation, their fee should not be disclosed as per related party transaction in accordance with Ind AS 24.

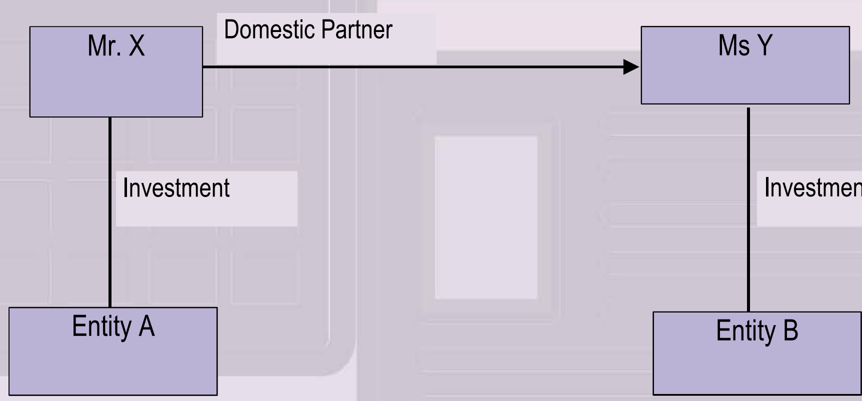
   Examine whether the sitting fee paid to independent director and non-executive director is required to be disclosed in the financial statements prepared as per Ind AS?

Answers

1. (a) If Mr. X controls or jointly controls A Limited, B Limited is related to A Limited when Ms. Y has control, joint control or significant influence over B Limited.

(b) If Mr. X controls or jointly controls A Limited, A Limited is related to B Limited when Ms. Y has control, joint control or significant influence over B Limited.

(c) No, Significant influence does not lead to direct/indirect control between the A Ltd. & B Ltd.



2. (a) C Limited is related to B Limited

(b) B Limited is related to C Limited

3. XYZ Ltd. would include the total revenue of Rs. 68,00,000 (Rs. 60,00,000 + Rs. 8,00,000) from ABC Ltd. received / receivable in the year ended 31st March 20X2 within its revenue and show Rs. 18,00,000 within trade receivables at 31st March 20X2.

Mrs. P would be regarded as a related party of XYZ Ltd. because she is a close family member of one of the key management personnel of XYZ Ltd.

From 1st June 20X1, ABC Ltd. would also be regarded as a related party of XYZ Ltd. because from that date ABC Ltd. is an entity controlled by another related party.

Because ABC Ltd. is a related party with whom XYZ Ltd. has transactions, then XYZ Ltd. should disclose:

– The nature of the related party relationship.

– The revenue of Rs. 60,00,000 from ABC Ltd. since 1st June 20X1.

– The outstanding balance of Rs. 18,00,000 at 31st March 20X2.

In the current circumstances it may well be necessary for XYZ Ltd. to also disclose the favourable terms under which the transactions are carried out.

4. As per paragraph 9 of Ind AS 24, Related Party Disclosures, "Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity."

Accordingly, key management personnel (KMP) includes any director of the entity who are having authority and responsibility for planning, directing and controlling the activities of the entity. Hence, independent director Mr. Atul and non-executive director Mr. Naveen are covered under the definition of KMP in accordance with Ind AS.

Also as per paragraph 7 and 9 of Ind AS 19, 'Employee Benefits', an employee may provide services to an entity on a full-time, part-time, permanent, casual or temporary basis. For the purpose of the Standard, Employees include directors and other management personnel.

Therefore, contention of the Accountant is wrong that they are not employees of X Ltd.

Paragraph 17 of Ind AS requires disclosure about employee benefits for key management personnel. Therefore, an entity shall disclose key management personnel compensation in total i.e. disclosure of directors' fee of (₹ 10,00,000 + ₹ 7,50,000) ₹ 17,50,000 is to be made as employees benefits (under various categories).

Since short-term employee benefits are expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related services, the sitting fee paid to directors will fall under it (as per Ind AS 19) and is required to be disclosed in accordance with the paragraph 17 of Ind AS 24.

UNIT 2: FINANCIAL INSTRUMENTS: EQUITY AND FINANCIAL LIABILITIES

2.1 INTRODUCTION

Ind AS 32 lays down the accounting principles for classifying a financial instrument issued by an entity as either a financial liability or equity or both (a compound instrument). The classification of a financial instrument is governed by the substance of a contract and not its legal form.

As you would see in the following paragraphs, classification of a financial instrument into financial liability or equity or compound involves analysis of each component of a contract. Incorrect classification results in misstatement of financial statements and significantly affects the financial ratios that are derived therefrom.

2.2 DEFINITIONS – FINANCIAL LIABILITY AND EQUITY

It is important to read paragraphs 11 and 16 of Ind AS 32 together to identify the accounting principles that distinguish a financial liability instrument from an equity instrument.

Before we look at the two definitions in a comparative format, it is important to highlight here that the classification of a financial instrument under Ind AS 32 is done from the perspective of the issuer and not from the perspective of the holder.

Financial liability (Ind AS 32.11)	Equity (Ind AS 32.16)
A financial instrument that fulfils **either of (A) or (B)** below: Condition (A): An instrument that **is a contractual obligation**: i. to deliver cash or another financial asset to another entity; or ii. to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity	A financial instrument that fulfils **both (A) and (B)** below: Condition (A): An instrument that contains **no contractual obligation**: i. to deliver cash or another financial asset to another entity; or ii. to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity

Condition (B): An instrument that will or may be settled in the entity's own equity instruments and is: i. a non-derivative **<u>for which the entity is or may be obliged</u>** to deliver a variable number of the entity's own equity instruments; or ii. a derivative that will or may be settled **<u>other than by</u>** the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.	Condition (B): An instrument that will or may be settled in the entity's own equity instruments and is: i. a non-derivative **<u>that includes no contractual obligation for the issuer</u>** to deliver a variable number of the entity's own equity instruments; or ii. a derivative that will or may be settled **<u>only by</u>** the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

As can be seen from the table above, the two definitions are mirror images of each other. In the following paragraphs, we will discuss each of these aspects in detail.

Importance of the phrase "contract" and "contractual"

It is important to know that 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing [Ind AS 32.13]. Liabilities that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities. Accounting for income taxes is dealt with in Ind AS 12. Similarly, constructive obligations, as defined in Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets, do not arise from contracts and are not financial liabilities.

Items such as deferred revenue and most warranty obligations are not financial liabilities because the outflow of economic benefits associated with them is the delivery of goods and services rather than a contractual obligation to pay cash or another financial asset. [Ind AS 32.AG11]

It should also be remembered that the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. For example, a financial guarantee is a contractual obligation of the guarantor to pay the lender, if the borrower defaults [Ind AS 32.AG8].

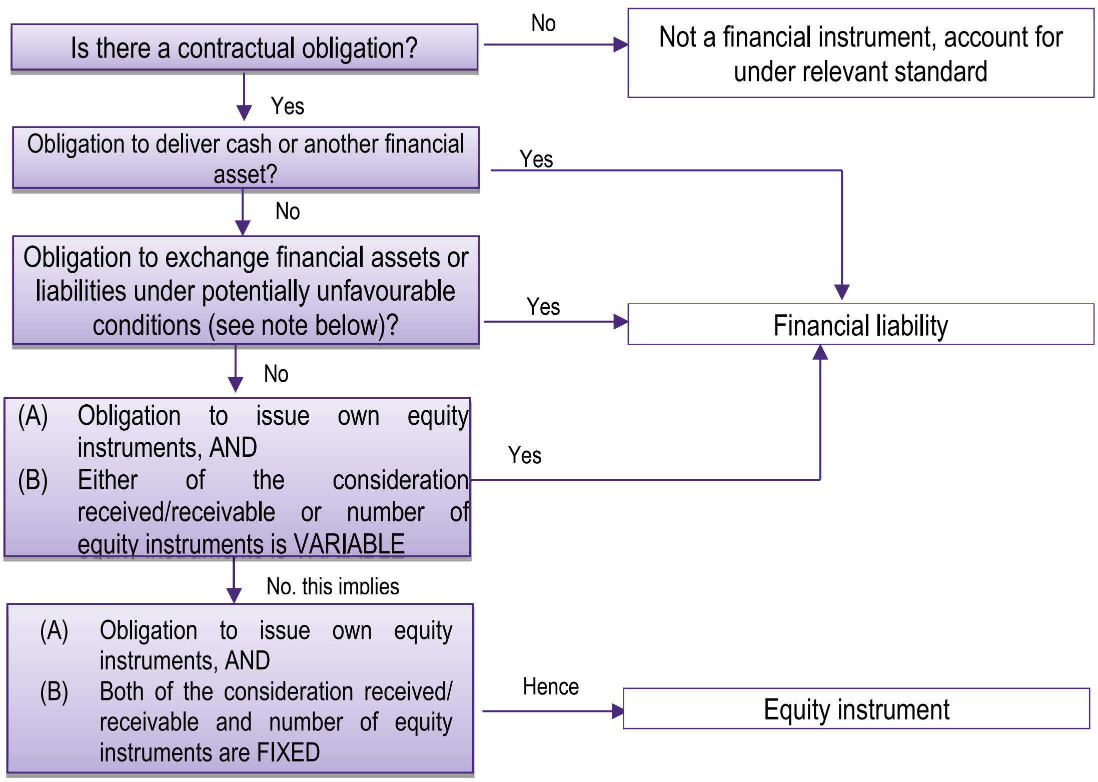
Analysis of the definitions

The following points must be remembered in determination of classification of a financial instrument as a financial liability or equity:

- ***Evaluation of components***- it is not always that the entire instrument is either a financial liability or equity. The issuer makes this determination for each component part of a contract in accordance with 'substance' thereof and definitions given above [Ind AS 32.15].

- ***Contract is supreme*** **-** The evaluation of 'substance' does not override or contravene the contractual terms.
- ***Contract cannot override laws*** **-** The entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or equity. Those terms and conditions include relevant local laws, regulations and the entity's governing charter in effect at the date of classification, but not expected future amendments to those laws, regulations or charter.

The flowchart below summarises the distinction between the definitions of a financial liability and equity:



Note: Potential unfavourable conditions

Example:

PQR Ltd. issues a call option (i.e. an option to buy) to ABC Ltd. to subscribe to PQR Ltd.'s equity shares at a price of ₹ 100 per share. The call option is to be settled on a 'net' basis i.e. without physical delivery of shares. If at the balance sheet date, market value of equity share of PQR Ltd. is ₹ 110 per share, PQR Ltd. will be obliged to pay ₹ 10 to settle the option. Such a condition is potentially unfavourable to PQR Ltd. and hence ₹ 10 represents a financial liability for PQR Ltd.

2.3 OBLIGATION TO DELIVER CASH

A critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of the issuer either to deliver cash or another financial asset to the holder or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer (Ind AS 32.17).

There are very limited exceptions to this principle in the form of "puttable instruments" and "obligations arising on liquidation". We will discuss these exceptions in the subsequent paragraphs, "Puttable instruments and obligations arising on liquidation".

The financial instrument is a financial liability even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease. [Ind AS 32.18(b)]

Subject to certain exceptions as mentioned above, if an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability. (Ind AS 32.19)

A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions. (Ind AS 32.20)

Illustration 1: Redeemable preference shares with mandatory dividend (refer Example 1 in section "Learning objective")

A Ltd. (issuer) issues preference shares to B Ltd. (holder). Those preference shares are redeemable at the end of 10 years from the date of issue and entitle the holder to a cumulative dividend of 15% p.a. The rate of dividend is commensurate with the credit risk profile of the issuer. Examine the nature of the financial instrument.

Solution

This instrument provides for mandatory fixed dividend payments and redemption by the issuer for a fixed amount at a fixed future date. Since there is a contractual obligation to deliver cash (for both dividends and repayment of principal) to the preference shareholder that cannot be avoided, the instrument is a financial liability in its entirety.

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Illustration 2: Redeemable debentures with discretionary dividend

X Co. Ltd. (issuer) issues debentures to Y Co. Ltd. (holder). Those debentures are redeemable at the end of 10 years from the date of issue. Interest of 15% p.a. is payable at the discretion of the issuer. The rate of interest is commensurate with the credit risk profile of the issuer. Examine the nature of the financial instrument.

Solution

This instrument has two components – (1) mandatory redemption by the issuer for a fixed amount at a fixed future date, and (2) interest payable at the discretion of the issuer.

The first component is a contractual obligation to deliver cash (for repayment of principal with or without premium, as per terms) to the debenture holder that cannot be avoided. This component of the instrument is a financial liability.

*****

Illustration 3: Perpetual loan with mandatory interest

P Co. Ltd. (issuer) takes a loan from Q Co. Ltd. (holder). The loan is perpetual and entitles the holder to fixed interest of 8% p.a. Examine the nature of the financial instrument.

Solution

This instrument has two components – (1) mandatory interest by the issuer for a fixed amount at a fixed future date, and (2) perpetual nature of the principal amount.

The first component is a contractual obligation to deliver cash (for payment of interest) to the lender that cannot be avoided. This component of the instrument is a financial liability.

*****

Illustration 4: Restriction on the ability of an entity to satisfy a contractual obligation

Does the lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, will lead to contractual obligation?

Solution

Lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate the entity's contractual obligation or the holder's contractual right under the instrument.

*****

Illustration 5: Optionally convertible redeemable preference shares

D Ltd. issues preference shares to G Ltd. The holder has an option to convert these preference shares to equity instruments of the issuer anytime up to a period of 10 years. If the option is not exercised by the holder, the preference shares are redeemed at the end of 10 years. Examine the nature of the financial instrument.

Solution

This instrument has two components – (1) contractual obligation that is conditional on holder exercising its right to redeem, and (2) conversion option with the holder.

The first component is a financial liability because the entity does not have the unconditional right to avoid delivering cash.

In the section "Compound financial instruments", we will also analyse the other component – the conversion option with the holder and we will explain the nature of the instrument in its entirety.

*****

Illustration 6: Settlement alternative is non-financial obligation

LMN Ltd. issues preference shares to PQR Ltd. These preference shares are redeemable at the end of 5 years from the date of issue.

The instrument also provides a settlement alternative to the issuer whereby it can transfer a particular commercial building to the holder, whose value is estimated to be significantly higher than the cash settlement amount. Examine the nature of the financial instrument.

Solution

Such preference shares are financial liability because the entity can avoid a transfer of cash or another financial asset only by settling the non-financial obligation.

*****

2.3.1 Puttable instruments and obligations arising on liquidation – Exceptions to classification as 'financial liability' for instruments settled in cash or another financial asset

Let us analyse this in the following two contexts:

A. Mutual funds and unit trusts, wherein the redemption amount is equal to a proportionate share in the net assets of the entity

B. Limited life entities like special purpose vehicles (SPV) for execution of an infrastructure project

First, let us look at one definition which is relevant for our discussion – "Puttable instrument" is a financial instrument that gives the holder:

- the right to put the instrument back to the issuer for cash or another financial asset, or
- is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

[The phrase "put back to the issuer" refers to redemption of the instrument. If the holder has a right, but not an obligation to require the issuer to redeem the instrument, it is referred to as "put option".]

As discussed above, financial instruments that contain an obligation of the issuer to deliver cash or another financial asset are classified as financial liabilities. As per this principle, the following shall be classified as financial liabilities:

- Puttable instruments (see context A above), and
- Instruments that create an obligation only on liquidation of the entity (see context B above). Liquidation may be certain to occur and outside issuer's control or uncertain to occur and at the option of holder.

However, Ind AS 32 contains an exception whereby such instruments are classified as "equity", despite the fact that they otherwise meet all the conditions for "financial liability". This exception applies if **all** of the following conditions are fulfilled by the instrument (Ind AS 32.16A, 16B, 16C and 16D):

1. It **entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation**. In other words, the instrument should not entitle its holder to a higher or lower share of entity's net assets upon liquidation.

   The logic behind this requirement is that entitlement to a pro rata share of the entity's net assets on liquidation is equivalent to having a residual interest in the assets of an entity.

   Illustration 7: Cap on amount payable on liquidation

   ABC Ltd. has two classes of puttable shares – Class A shares and Class B shares. On liquidation, Class B shareholders are entitled to a pro rata share of the entity's residual assets up to a maximum of ₹ 10,000,000.

   There is no limit to the rights of the Class A shareholders to share in the residual assets on liquidation. Examine the nature of the financial instrument.

   Solution

   The cap of ₹ 10,000,000 means that Class B shares do not have entitlement to a pro rata share of the residual assets of the entity on liquidation. They cannot therefore be classified as equity.

*****

2. It is in the class of instruments that is **subordinate to all other classes of instruments**, that is, in its present form, it has no priority over other claims to the entity's assets **on liquidation** (entity will need to assume liquidation on date of classification).

   Illustration 8: Investment manager's share in a mutual fund

   Mutual Fund X has an Investment Manager Y. At the inception of the fund, Y had invested a nominal or token amount in units of X. Such units rank last for repayment in the event of liquidation. Accordingly, they constitute the most subordinate class of instruments. Examine the nature of the financial instrument.

Solution

Resultantly, the units held by other unit holders are classified as financial liability as they are not the most subordinate class of instruments – they are entitled to pro rate share of net assets on liquidation, and their claim has a priority over claims of Y.

It may be noted that the most subordinate class of instruments may consist of two or more legally separate types of instruments.

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3. (a) In case of puttable instruments, all financial instruments in the most subordinate class have **identical features**: For example, they must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class.

Illustration 9: Differential voting rights

T Motors Ltd. has issued puttable ordinary shares and puttable 'A' ordinary shares whereby holders of ordinary shares are entitled to one vote per share whereas holders of 'A' ordinary shares are not entitled to any voting rights. The holders of two classes of shares are equally entitled to receive share in net assets upon liquidation. Examine whether the financial instrument will be classified as equity.

Solution

Neither of the two classes of puttable shares can be classified as equity, as they do not have identical features due to the difference in voting rights. It is not possible for T Motors Ltd. to achieve equity classification of the ordinary shares by designating them as being more subordinate than the 'A' ordinary shares, as this does not reflect the fact that the two classes of share are equally entitled to share in entity's residual assets on liquidation.

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(b) In contrast to the above, in case of instruments that impose on the entity an obligation to deliver pro rata share of net assets only on liquidation, all financial instruments in the most subordinate class have such identical contractual obligation.

4. In case of puttable instruments, apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, there are **no other contractual obligations**:

- to deliver cash or another financial asset, or
- to settle in variable number of entity's own equity instruments

In other words, there are no other features of the instrument which could satisfy the definition of "financial liability".

Illustration 10: Conversion into a variable number of equity instruments

S Ltd. has issued a class of puttable ordinary shares to T Ltd. Besides the put option (which is consistent with other classes of ordinary shares), T Ltd. is also entitled to convert the class of ordinary shares held by it into equity instruments of S Ltd. whose number will vary as per the market value of S Ltd. Examine whether the financial instrument will be classified as equity.

Solution

The shares cannot qualify for equity classification in their entirety as in addition to the put option there is also a contractual obligation to settle the instrument in variable number of entity's own equity instruments.

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5. In case of puttable instruments, the **<u>total expected cash flows attributable to the instrument</u>** over the life of the instrument are based substantially on the:

   - profit or loss,
   - change in the recognised net assets or
   - change in the fair value of the recognised and unrecognised net assets

   of the entity over the life of the instrument (excluding any effects of the instrument).

   In other words, if the cash flows are attributable to any factors other than the three listed above, for example, an index, the puttable instrument will fail the equity classification.

6. The issuer must have **<u>no other financial instrument or contract</u>** that has:

   - total cash flows on same terms as (5) above, with
   - the effect of substantially restricting or fixing the residual return to the puttable instrument holders.

   The intent behind this "anti-abuse" clause is to ensure that puttable instruments are not artificially structured to satisfy conditions (1) to (5) above and at the same time the holder of that puttable instrument also holds another financial instrument or has entered into another contract with the issuer whose cash flows indirectly restrict or fix the return on puttable instrument.

   However, "another financial instrument" held by or "another contract" entered into, by the holder of puttable instrument, in its capacity as non-owner of puttable instrument, does not affect the classification of the puttable instrument.

Illustration 11: Management fee contract between issuer and puttable instrument holder

P Ltd. has issued puttable ordinary shares to Q Ltd. Q Ltd. has also entered into an asset management contract with P Ltd. whereby Q Ltd. is entitled to 50% of the profit of P Ltd. Normal commercial terms for similar contracts will entitle the service provider to only 4%-6% of the net profits. Examine whether the financial instrument will be classified as equity.

Solution

The puttable ordinary shares cannot qualify for equity classification as (a) in addition to the put option, there is another contract between the issuer (P Ltd.) and holder of puttable instrument (Q Ltd.) whose cash flows are based substantially on profit or loss of issuer, (b) whose contractual terms are not similar to a contract between a non-instrument holder and issuer and (c) it has the effect of substantially restricting return on puttable ordinary shares.

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If the terms of asset management contract were assessed to be similar to terms of a contract between a non-instrument holder and the issuer, it would not have precluded equity classification for puttable shares, provided other conditions are met.

To summarise, the following conditions are required to be fulfilled in each of the two contexts set out at the beginning of this paragraphs:

- **Puttable instruments** (see context A above) – conditions (1) to (6)
- **Instruments that create an obligation only on liquidation of the entity** (see context B above) – conditions (1) to (3) and condition (6).

2.3.1.1 Reclassification

- **Date of classification** of a financial instrument as an equity instrument in accordance with exceptions mentioned above – from the date when the instrument has all the features and meets the conditions set out above (Ind AS 32.16E).
- **Date of reclassification** of a financial instrument – from the date when the instrument ceases to have all the features or meet all the conditions set out above (Ind AS 32.16E).

  For example, if an entity redeems all its issued non-puttable instruments and any puttable instrument that remain outstanding have all the features and meet all the conditions mentioned above, the entity shall reclassify the puttable instruments as equity instruments from the date when it redeems the non-puttable instruments.
- **Accounting for reclassification** (Ind AS 32.16F):

Reclassification from	Reclassification to	Measurement	Recognition of difference in carrying amount and measurement of reclassified instrument
Financial liability	Equity	Carrying value at date of reclassification	-N.A.-
Equity	Financial liability	Fair value at date of reclassification	In equity

2.3.2 Obligation to purchase own equity instruments

With the exception of the circumstances described above (paragraphs 16A and 16B or paragraphs 16C and 16D of Ind AS 32), a contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount. This is the case even for derivatives over equity instruments that meet the fixed for fixed test and would be equity in the absence of this rule. (Ind AS 32.23)

Illustration 12: Written put option on own equity instruments

On 1 January 20X1, Entity X writes a put option over 1,00,000 of its own equity shares for which it receives a premium of ₹ 5,00,000.

Under the terms of the option, Entity X may be obliged to take delivery of 1,00,000 of its own shares in one year's time and to pay the option exercise price of ₹ 22,000,000. The option can only be settled through physical delivery of the shares (gross physical settlement). Examine the nature of the financial instrument and how it will be accounted.

Solution

This derivative involves Entity X taking delivery of a fixed number of equity shares for a fixed amount of cash. Even though the obligation for Entity X to purchase its own equity shares for ₹ 22,000,000 is conditional on the holder of the option exercising the option, Entity X has an obligation to deliver cash which it cannot avoid.

The accounting for financial instrument in the above illustration is as below (Ind AS 32.23):

- The financial liability is recognised initially at the present value of the redemption amount, and is reclassified from equity – In the illustration above, this would imply that a financial liability for an amount of present value of ₹ 22,000,000, say ₹ 20,000,000 will be recognised through a debit to equity. The initial premium received (₹ 500,000) is credited to equity.
- Subsequently, the financial liability is measured in accordance with Ind AS 109. While a subsequent paragraph will deal with measurement of financial liabilities, the financial liability of ₹ 20,000,000 in the aforementioned illustration will be measured at amortised cost and finance cost of ₹ 2,000,000 will be recognised over the exercise period.
- If the contract expires without delivery, the carrying amount of the financial liability is reclassified to equity. This means, in case of illustration above, an amount of ₹ 22,000,000 will be reclassified from financial liability to equity.

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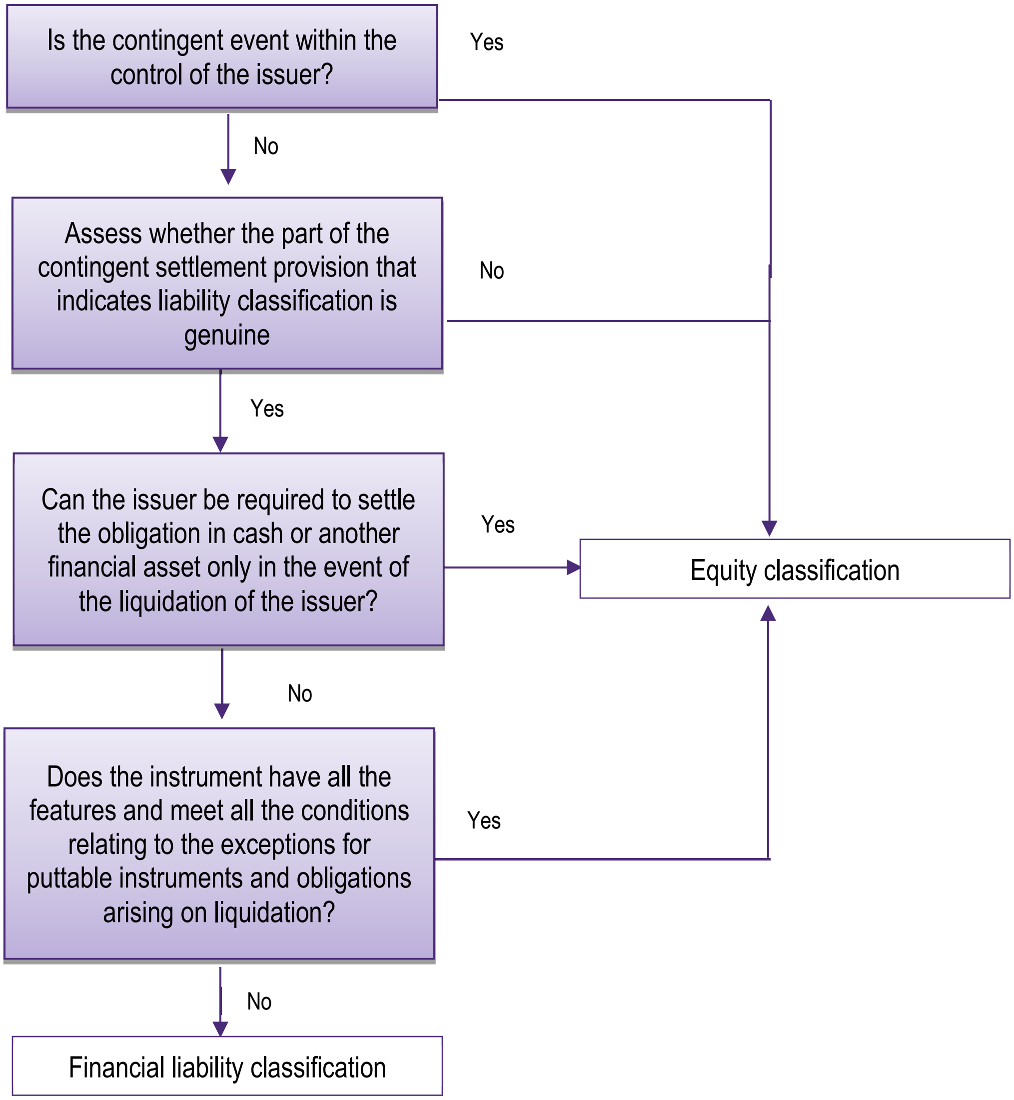
2.3.3 Contingent settlement provisions

A financial instrument may require an entity to deliver cash or another financial asset, or settle it in some other way that would require it to be classified as a financial liability, but only in the event of the occurrence or non-occurrence of some uncertain future event. The 'event' may be within the control of the issuer or of the holder, or beyond the control of both. These types of contractual arrangements are referred to as 'contingent settlement provisions'.

The flowchart below explains the classification process for contingent settlement provisions:



2.3.4 Written put options over non-controlling interests

In consolidated financial statements, an entity presents non-controlling interests—ie the interests of other parties in the equity and income of its subsidiaries – in accordance with Ind AS 1 and Ind AS 110. When classifying a financial instrument (or a component of it) in consolidated financial statements, an entity considers all terms and conditions agreed between members of the group and the holders of the instrument in determining whether the group as a whole has an obligation to deliver cash or another financial asset in respect of the instrument or to settle it in a manner that results in liability classification.

When a subsidiary in a group issues a financial instrument and a parent or other group entity agrees additional terms directly with the holders of the instrument (eg a guarantee), the group may not have discretion over distributions or redemption. Although the subsidiary may appropriately classify the instrument without regard to these additional terms in its individual financial statements, the effect of other agreements between members of the group and the holders of the instrument is considered in order to ensure that consolidated financial statements reflect the contracts and transactions entered into by the group as a whole.

To the extent that there is such an obligation or settlement provision, the instrument (or the component of it that is subject to the obligation) is classified as a financial liability in consolidated financial statements. (Ind AS 32.AG29)

Illustration 13: Written put option over non-controlling interests

Parent P holds a 70% controlling interest in Subsidiary S. The remaining 30% is held by Entity Z. On 1 January 20X1, P writes an option to Z which grants Z the right to sell its shares to Parent P on 31 December 20X2 for ₹ 1,000. Parent P receives a payment of ₹ 100 for the option. The applicable discount rate for the put liability is determined to be 12%. State by which amount the financial instrument will be recognised and under which category.

Solution

On 1 January 20X1, the present value of the (estimated) exercise price is ₹ 797 (₹ 1,000 discounted over 2 years at 12%).

Accordingly, P will recognise a financial liability of ₹ 797 and the difference between cash received i.e. ₹ 1000 and the financial liability of ₹ 797 will be debited to equity.

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2.4 SETTLEMENT IN ENTITY'S OWN EQUITY INSTRUMENTS

A financial instrument is classified as a liability not just when there is an obligation to deliver cash or another financial asset. It is **sometimes** so classified even when the entity's obligation is to settle the instrument through delivery of its own equity instruments.

Let us evaluate two alternate situations for an instrument that is convertible at the option of the issuer:

Illustration 14: Conversion into a number of equity instruments equivalent to a fixed value

CBA Ltd. issues convertible debentures to RQP Ltd. for a subscription amount of ₹ 100 crores. Those debentures are convertible after 5 years into equity shares of CBA Ltd. using a pre-determined formula. The formula is:

$$\frac{100 \text{ crores } X \ (1+10\%)^{\wedge}5}{\text{Fair value on date of conversion}}$$

Examine the nature of the financial instrument.

Solution

Such a contract is a financial liability of the entity even though the entity can settle it by delivering its own equity instruments. It is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract. The underlying thought behind this conclusion is that the entity is using its own equity instruments 'as currency'.

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Illustration 15: Conversion into a fixed number of equity instruments

DF Ltd. issues convertible debentures to JL Ltd. for a subscription amount of ₹ 100 crores. Those debentures are convertible after 5 years into 15 crore equity shares of ₹ 10 each.

Examine the nature of the financial instrument.

Solution

This contract is an equity instrument because changes in the fair value of equity shares arising from market related factors do not affect the amount of cash or other financial assets to be paid or received, or the number of equity instruments to be received or delivered.

From the above two situations, we can conclude as below:

- A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. **If an entity has a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligation, such a contract is a financial liability**. Such a contractual right or obligation may be for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments (eg an interest rate, a commodity price or a financial instrument price). (Ind AS 32.21). The number of equity instruments to be delivered could vary as a result of entity's own share price. [Ind AS 32.AG27(d)]

- **A contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument**. (Ind AS 32.22)

The above requirements are summarised in the table below:

S. No.	Consideration for financial instrument	Number of own equity instruments to be issued in settlement	Classification and rationale
1	Fixed	Variable	Financial liability – own equity instruments are being used as currency to settle an obligation for a fixed amount
2	Fixed	Fixed	Equity – issuer does not have an obligation to pay cash and holder is not exposed to any variability
3	Variable	Fixed	Financial liability – though issuer does not have an obligation to pay cash, but holder is exposed to variability
4	Variable	Variable	Financial liability – though issuer does not have an obligation to pay cash, but both parties are exposed to variability

The principle at serial number 2 in table above is also called **"fixed for fixed" test** i.e. fixed amount of cash or other financial asset for fixed number of own equity instruments.

Another point to note is a fine distinction highlighted in the definition of financial liability and equity, as mentioned in the paragraph "Definitions – financial liability and equity". Being mirror images of each other, for simplicity sake, let us look at condition (B) in the definition of "financial liability":

"An instrument that will or may be settled in the entity's own equity instruments and is:

i. a **non-derivative** for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

ii. a **derivative** that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments."

Please note the highlighted words in the definition. Illustration 12 and 13 above depict the classification of a non-derivative instrument. A derivative instrument, on the other hand, inter alia, would involve little initial net investment. The following example illustrates the context in which the aforementioned definition is to be read.

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Illustration 16: Written option for a fixed or variable number of equity instruments

ST Ltd. purchases an option from AT Ltd. entitling the holder to subscribe to equity shares of issuer at a fixed exercise price of ₹ 50 per share at any time during a period of 3 months. Holder paid an initial premium of ₹ 2 per option. Examine whether the financial instrument will be classified as equity.

Solution

For the issuer AT Ltd., this option is an equity instrument as it will be settled by the exchange of a fixed amount of cash for a fixed number of its own equity instruments.

If, on the other hand, if the exercise price of the option was variable, say benchmarked to an index or a variable, other than the market price of equity shares of AT Ltd., the written option will be classified as a "financial liability" in the books of the issuer, AT Ltd.

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For more discussion on derivative instruments, refer Unit 5: Derivatives and Embedded derivatives.

In the above illustration, if the instrument is classified as "equity instrument", any consideration received (such as the premium received for a written option or warrant on the entity's own shares) is added directly to equity. It must also be noted that changes in the fair value of an equity instrument are not recognised in the financial statements. (Ind AS 32.22)

On the contrary, if the derivative instrument (i.e. the written option) is classified as "financial liability", any consideration received is measured initially at fair value and subsequently also at fair value, with fair value changes recognised in profit or loss. For detailed discussion on measurement of financial liabilities, refer Unit 3.

The chart below summarises the discussion above:

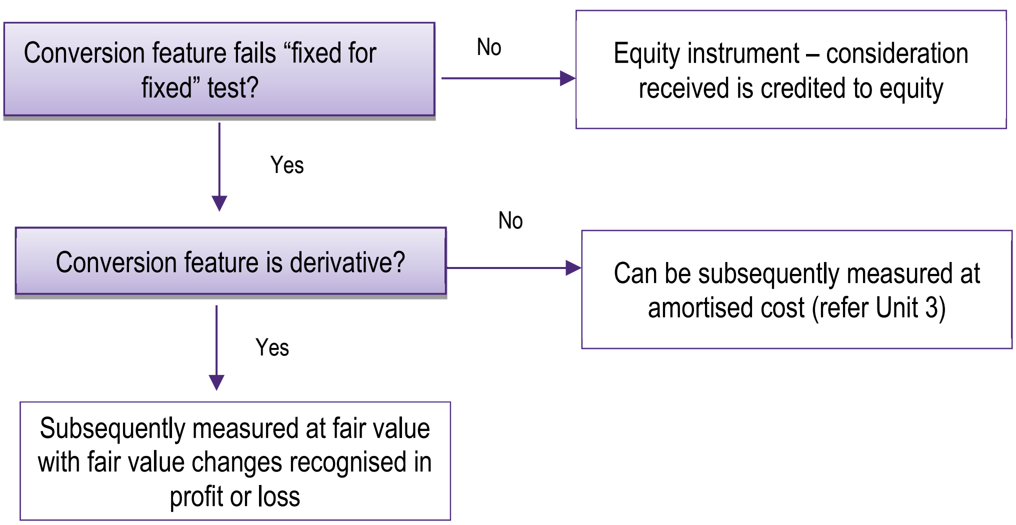

Illustration 17: Written option with multiple exercise prices

WC Ltd. writes an option in favour of GT Ltd. wherein the holder can purchase issuer's equity instruments at prices that fluctuate in response to the share price of issuer.

As per the terms, if the share price of issuer is less than ₹ 50 per share, option can be exercised at ₹ 40 per share. If the share price is equal to or more than ₹ 50 per share, option can be exercised at ₹ 60 per share. Explain the nature of the financial instrument.

Solution

As the contract will be settled by delivery of fixed number of instruments for a variable amount of cash, it is a financial liability.

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Illustration 18: Share swap arrangements

Acquirer Ltd. enters into an arrangement with shareholders of Target Ltd. wherein Acquirer Ltd. will purchase shares of Target Ltd. in a share swap arrangement against a variable amount of cash i.e. market value of Target Ltd.'s equity shares. The share swap ratio is agreed as 1:5 i.e. 1 equity share of Acquirer Ltd. for every 5 equity shares held in Target Ltd. Examine whether the financial instrument will be classified as equity.

Solution

Such arrangements will not meet the condition for classification as "equity instrument" since the contract will be settled by delivery of fixed number of Acquirer Ltd.'s own equity instruments against a variable amount of cash i.e. market value of Target Ltd.'s equity shares.

Such a contract will likely result in a derivative liability or asset for both the parties.

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Illustration 19: Conversion ratio changes with time

On 1 January 20X1, NKT Ltd. subscribes to convertible preference shares of VT Ltd. The conversion ratio varies as below:

Conversion upto 31 March 20X1: 1 equity share of VT Ltd. for each preference share held

Conversion upto 30 June 20X1: 1.5 equity share of VT Ltd. for each preference share held

Conversion upto 31 December 20X1: 2 equity share of VT Ltd. for each preference share held.

Examine whether the financial instrument will be classified as equity.

Solution

The convertible preference shares can be classified as "equity instrument" in the books of the issuer, VT Ltd. The conversion ratio doesn't change corresponding to any underlying variable, it only varies in response to passage of time which is a certain event and hence fixed.

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Illustration 20: Conversion ratio changes to protect rights of convertible instrument holders

On 1 January 20X1, HT Ltd. subscribes to convertible preference shares of RT Ltd. The preference shares are convertible in the ratio of 1:1.

The terms of the instrument entitle HT Ltd. to proportionately more equity shares of RT Ltd. in case of a stock split or bonus issue. Examine whether the financial instrument will be classified as equity.

Solution

The convertible preference shares can be classified as "equity instrument" in the books of the issuer, RT Ltd. The variability in the conversion ratio is only to protect the rights of the holder of convertible instrument vis-à-vis other equity shareholders.

The conversion was always intended to be in a fixed ratio and hence the holder is exposed to the change in equity value. The variability is brought in to maintain holder's exposure in line with other holders.

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Illustration 21: Conversion ratio changes if issuer subsequently issues shares to others at a lower price

On 1 January 20X1, PG Ltd. subscribes to convertible preference shares of BG Ltd. at ₹ 100 per preference share. The preference shares are convertible in the ratio of 10:1 i.e. 10 equity shares for each preference share held. On a fully diluted basis, PG Ltd. is entitled to 30% stake in BG Ltd.

If subsequent to the issuance of these convertible preference shares, BG Ltd. issues any equity instruments at a price lower than ₹ 10 per share, conversion ratio will be changed to compensate PG Ltd. for dilution in its stake below the expected dilution at a price of ₹ 10 per share. Examine the nature of the financial instrument.

Solution

The convertible preference shares will be classified as "financial liability" in the books of the issuer, BG Ltd. The variability in the conversion ratio underwrites the return on preference shares and not just protects the rights of convertible instrument holders vis-à-vis equity shareholders.

*****

Illustration 22: Conversion ratio is variable in a narrow range

On 1 January 20X1, NG Ltd. subscribes to convertible preference shares of AG Ltd. at ₹ 100 per preference share. On a fully diluted basis, NG Ltd. is entitled to 30% stake in AG Ltd.

The preference shares are convertible at fair value, subject to, NG Ltd.'s stake not going below 15% and not going above 40%. Examine the nature of the financial instrument.

Solution

The convertible preference shares will be classified as "financial liability" in the books of the issuer, AG Ltd. The variability in the conversion ratio underwrites the return on preference shares to an extent and also restricts that return. The preference shareholder is not entitled to residual net assets of the issuer.

In certain situations, an instrument is convertible only at the option of issuer. While such instruments provide the issuer with an unconditional right to avoid payment of cash, it is important to understand the economic substance of the option. It is also very important to determine whether the option is exercised by the issuer or by shareholders acting in their capacity as instrument holders.

For example, if the convertible instrument is held by the equity shareholders of the issuer and the conversion requires unanimous consent of all the shareholders, it would be inappropriate to consider that the issuer has an unconditional right to avoid payment of cash. In this situation, it would be more relevant to consider the rights of the instrument holders in their capacity as equity shareholders of the issuer.

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Illustration 23: Instrument convertible only at the option of issuer

XYZ Ltd. issues optionally convertible debentures with the following terms:

The debentures carry interest at the rate of 7% p.a.

Issuer has option to either:

Convert the instrument into a fixed number of its own shares at any time, or redeem the instrument in cash at any time. The redemption price is the fair value of the fixed number of shares into which the instrument would have converted if it had been converted.

The holder has no conversion or redemption options.

Debentures have a tenor of 12 years and, if not converted or redeemed earlier, will be repaid in cash at maturity, including accrued interest, if any.

Examine the nature of the financial instrument.

Solution

The issuer has the ability to convert the debentures into a fixed number of its own shares at any time. The issuer, therefore, has the ability to avoid making a cash payment or settling the debentures in a variable number of its own shares. Therefore, such a financial instrument is likely to be classified as equity.

However, it must be noted that mere existence of a right to avoid payment of cash is not conclusive. The instrument is to be accounted for as per its substance and hence it needs to be seen whether the conversion option is substantive.

In this particular situation, the issuer will need to determine whether it is favourable to exercise the conversion option or redemption option. In case of latter, the instrument will be classified as a financial liability (a hybrid instrument, whose measurement is dealt with in a subsequent section).

Practical situations do arise wherein the issuer has an option or obligation to issue own equity instruments only in particular circumstances i.e. the instrument is contingently convertible.

*****

Illustration 24: Conversion ratio changes under independent scenarios

On 1 January 20X1, STAL Ltd. subscribes to convertible preference shares of ATAL Ltd.

The preference shares are convertible as below:

Convertible 1:1 if another strategic investor invests in the issuer within one year

Convertible 1.5:1: if an IPO is successfully completed within 2 years

Convertible 2:1: if a binding agreement for sale of majority stake by equity shareholders is entered into within 3 years

Convertible 3:1: if none of these events occur in 3 years' time.

Examine whether the financial instrument will be classified as equity.

Solution

In this case the four events can be viewed as discrete because the achievement of each one of these can occur independently of the other (as they relate to different periods). The arrangement can therefore be considered to be economically equivalent to four separate contracts. The price per share and the amount of shares to be issued is fixed in each of these discrete periods, with each event relating to a different year and therefore a separate risk. The "fixed for fixed" test is therefore met.

The instrument is therefore classified as "equity instrument".

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Illustration 25: Conversion ratio changes under inter-dependent scenarios

On 1 January 20X1, RHT Ltd. subscribes to convertible preference shares of RDT Ltd.

The preference shares are convertible as below:

Convertible 1:1 if another strategic investor invests at an enterprise valuation (EV) of USD 100 million.

Convertible 1.5:1: if another strategic investor invests at EV of USD 150 million

Convertible 2:1: if another strategic investor invests at EV of USD 200 million

Convertible 3:1: if no strategic investment is made within a period of 3 years

Examine the nature of the financial instrument.

Solution

The four events are interdependent because the second event cannot be met without also meeting the first event, and the third event cannot be met unless the first two are met.

Therefore, this contract should be treated as a single instrument when applying the "fixed for fixed" test. The test is then failed because the number of shares to be exchanged for cash are variable.

*****

2.4.1 Settlement Options

When a derivative financial instrument gives one party a choice over how it is settled, it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument. (Ind AS 32.26)

For instance - a share option that the issuer can decide to settle net in cash or by exchanging its own shares for cash is a financial liability.

2.4.2 Settlement by delivery of instruments that meet conditions for exceptions to classification as financial liability

If the entity's own equity instruments to be received, or delivered, by the entity upon settlement of a contract are:

- puttable financial instruments with all the features and meeting the conditions described in paragraphs 16A and 16B of Ind AS 32 (as discussed above), or
- instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation with all the features and meeting the conditions described in paragraphs 16C and 16D of Ind AS 32 (as discussed above),

the contract is a financial asset or a financial liability.

This includes a contract that will be settled by the entity receiving or delivering a fixed number of such instruments in exchange for a fixed amount of cash or another financial asset. (Ind AS 32.22A)

2.4.3 Rights issues, options or warrants to acquire entity's own equity instruments for any currency

Rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. (Ind AS 32.11)

Carve out from IFRS: Equity conversion option embedded in a foreign currency convertible bond

Ind AS 32 considers the equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of entity's own equity instruments as an equity instrument if the exercise price is fixed in any currency.

Let's understand this carve-out from IFRS using an illustration:

Illustration 26: Foreign currency convertible bond

Entity A issues a bond with face value of USD 100 and carrying a fixed coupon rate of 6% p.a. Each bond is convertible into 1,000 equity shares of the issuer. Examine the nature of the financial instrument.

Solution

While the number of equity shares is fixed, the amount of cash is not. The variability in cash arises on account of fluctuation in exchange rate of INR-USD. Such a foreign currency convertible bond (FCCB) will qualify the definition of "financial liability".

However, Ind AS 32.11 provides, "the equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of the entity's own equity instruments is an equity instrument if the exercise price is fixed in any currency."

Accordingly, FCCB will be treated as an "equity instrument".

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2.5 COMPOUND FINANCIAL INSTRUMENTS

So far we have discussed two broad aspects of classification:

- Obligations to deliver cash – generally, instruments with such obligations are classified as "financial liability"
- Settlement in own equity instruments – generally, instruments with such provisions are classified as "equity"

There are several exceptions to the general principles stated above, as we have seen in several illustrations discussed so far.

Let us now study those instruments which have features of both a financial liability and equity instrument. Such instruments are called "compound financial instruments". This topic is aimed at discussing the accounting treatment of such instruments and practical complexities that are arise due to issuance of such instruments.

The following illustrations demonstrate the identification of separate components of a financial instrument and determining whether it is a compound financial instrument.

Illustration 27: Redeemable debentures with discretionary dividend (continued from Illustration 2)

X Co. Ltd. (issuer) issues debentures to Y Co. Ltd. (holder). Those debentures are redeemable at the end of 10 years from the date of issue. Interest of 15% p.a. is payable at the discretion of the issuer. The rate of interest is commensurate with the credit risk profile of the issuer. Examine the nature of the financial instrument.

Solution

This instrument has two components – (1) mandatory redemption by the issuer for a fixed amount at a fixed future date, and (2) interest payable at the discretion of the issuer.

The first component is a contractual obligation to deliver cash (for repayment of principal with or without premium, as per terms) to the debenture holder that cannot be avoided. This component of the instrument is a financial liability.

The other component, discretionary interest is an equity feature because issuer can avoid payment of cash or another financial asset in this respect.

Therefore, this instrument is concluded to be a compound financial instrument.

*****

Illustration 28: Perpetual loan with mandatory interest (continued from Illustration 3)

P Co. Ltd. (issuer) takes a loan from Q Co. Ltd. (holder). The loan is perpetual and entitles the holder to fixed interest of 8% p.a. Examine the nature of the financial instrument.

Solution

This instrument has two components – (1) mandatory interest by the issuer for a fixed amount at a fixed future date, and (2) perpetual nature of the principal amount.

The first component is a contractual obligation to deliver cash (for payment of interest) to the lender that cannot be avoided. This component of the instrument is a financial liability.

The other component, perpetual principal, is an equity feature because issuer is not required to pay cash or another financial asset in this respect.

Therefore, this instrument is concluded to be a compound financial instrument.

*****

Illustration 29: Optionally convertible redeemable preference shares (continued from Illustration 5)

D Ltd. issues preference shares to G Ltd. The holder has an option to convert these preference shares to equity instruments of the issuer anytime up to a period of 10 years. If the option is not exercised by the holder, the preference shares are redeemed at the end of 10 years. Examine the nature of the financial instrument.

Solution

This instrument has two components – (1) contractual obligation that is conditional on holder exercising its right to redeem, and (2) conversion option with the holder.

The first component is a financial liability because the entity does not have the unconditional right to avoid delivering cash.

The other component, conversion option with the holder, is an equity feature if the "fixed for fixed" test is satisfied. If the conversion option does not fulfil that test, say, because the conversion ratio varies in response to an underlying variable, it is a derivative liability.

Such an instrument is called a "hybrid instrument".

*****

2.5.1 Split accounting for compound financial instruments

Ind AS 109 deals with the measurement of financial assets and financial liabilities. Equity instruments are instruments that evidence a residual interest in the assets of an entity after deducting all of its liabilities. Therefore, when the initial carrying amount of a compound financial instrument is allocated to its equity and liability components:

- the equity component is assigned the residual amount i.e.
  - fair value of the instrument as a whole, *less*
  - the amount separately determined for the liability component.
- The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the fair value that would be ascribed to the instrument as a whole.
- No gain or loss arises from initially recognising the components of the instrument separately.

(Ind AS 32.31)

In Illustrations 28 and 29 above, split accounting is performed by first determining the carrying amount of the liability component. This is done by measuring the net present value of the discounted cash flows of interest and/or principal, ignoring the possibility of exercise of the conversion option, if any. The discount rate is the market rate at the time of inception for a similar liability that does not have an associated equity component. The carrying amount of the equity instrument represented by perpetual principal in Illustration 28 and conversion option in Illustration 29 is then determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole.

Illustration 30: Perpetual loan with mandatory interest (continued from Illustration 3)

P Co. Ltd. (issuer) takes a loan from Q Co. Ltd. (holder) for ₹ 12 lakhs. The loan is perpetual and entitles the holder to fixed interest of 8% p.a. The rate of interest commensurate with credit risk profile of the issuer is 12% p.a. Calculate the value of the liability and equity components.

Solution

The values of the liability and equity components are calculated as follows:

Present value of interest payable in perpetuity (₹ 96,000 discounted at 12%) = ₹ 800,000

Therefore, equity component = fair value of compound instrument, say, ₹ 1,200,000 less financial liability component i.e. ₹ 800,000 = ₹ 400,000.

In subsequent years, the profit and loss account is charged with interest of 12% on the debt instrument.

*****

Illustration 31: Optionally convertible redeemable preference shares (continued from Illustration 29)

On 1 July 20X1, D Ltd. issues preference shares to G Ltd. for a consideration of ₹ 10 lakhs. The holder has an option to convert these preference shares to a fixed number of equity instruments of the issuer anytime up to a period of 3 years. If the option is not exercised by the holder, the preference shares are redeemed at the end of 3 years. The preference shares carry a fixed coupon of 6% p.a. The prevailing market rate for similar preference shares, without the conversion feature, is 9% p.a.

Calculate the value of the liability and equity components.

Solution

The values of the liability and equity components are calculated as follows:

Present value of principal payable at the end of 3 years (₹ 10 lakhs discounted at 9% for 3 years) = ₹ 772,183

Present value of interest payable in arrears for 3 years (₹ 60,000 discounted at 9% for each of 3 years) = ₹ 151,878

Total financial liability = ₹ 924,061

Therefore, equity component = fair value of compound instrument, say, ₹ 1,000,000 less financial liability component i.e. ₹ 924,061 = ₹ 75,939.

In subsequent years, the profit and loss account is charged with interest of 9% on the debt instrument.

*****

2.5.2 Separation of non-equity embedded derivatives

Sometimes, the issuer also has the option to early redeem the instrument mentioned in Illustration 31. Such an option is issuer's call option. This call option is considered an embedded derivative which is a financial liability. The value of any derivative features (such as a call option) embedded in the compound financial instrument other than the equity component (such as an equity conversion option) is included in the liability component. (Ind AS 32.31)

Illustration 32: Optionally convertible preference shares with issuer's redemption option

D Ltd. issues preference shares to G Ltd. for a consideration of ₹ 10 lakhs. The holder has an option to convert these preference shares to a fixed number of equity instruments of the issuer anytime up to a period of 3 years. If the option is not exercised by the holder, the preference shares are redeemed at the end of 3 years. The preference shares carry a coupon of RBI base rate plus 1% p.a.

The prevailing market rate for similar preference shares, without the conversion feature or issuer's redemption option, is RBI base rate plus 4% p.a. On the date of contract, RBI base rate is 9% p.a.

Calculate the value of the liability and equity components.

Solution

The values of the liability and equity components are calculated as follows:

Present value of principal payable at the end of 3 years (₹ 10 lakhs discounted at 13% for 3 years) = ₹ 6,93,050

Present value of interest payable in arrears for 3 years (₹ 100,000 discounted at 13% for each of 3 years) = ₹ 2,36,115

Paragraph AG 31 of Ind AS 32 states that a common form of compound financial instruments is a debt instrument with an embedded conversion option, such as a bond convertible into ordinary shares of the issuer, and without any other embedded derivatives features.

The liability component = Present value of principal + Present value of Interest

= ₹ 6,93,050 + ₹ 2,36,115 = ₹ 9,29,165

Equity Component = ₹ 10,00,000 – ₹ 9,29,165 = ₹ 70,835

*****

2.5.3 Conversion or early settlement of compound financial instruments

2.5.3.1Conversion

Classification of the liability and equity components of a convertible instrument is not revised as a result of a change in the likelihood that a conversion option will be exercised, even when exercise of the option may appear to have become economically advantageous to some holders. Holders may not always act in the way that might be expected because, for example, the tax consequences resulting from conversion may differ among holders. Furthermore, the likelihood of conversion will change from time to time. The entity's contractual obligation to make future payments remains outstanding until it is extinguished through conversion, maturity of the instrument or some other transaction. (Ind AS 32.30)

On conversion of a convertible instrument at maturity, the entity:

- derecognises the liability component and
- recognises it as equity.
- original equity component remains as equity (although it may be transferred from one line item within equity to another).
- there is no gain or loss on conversion at maturity.

2.5.3.2Early settlement

When an entity extinguishes a convertible instrument before maturity through an early redemption or repurchase in which the original conversion privileges are unchanged, the entity allocates the consideration paid and any transaction costs for the repurchase or redemption to the liability and equity components of the instrument at the date of the transaction. The method used in allocating the consideration paid and transaction costs to the separate components is consistent with that used in the original allocation to the separate components of the proceeds received by the entity when the convertible instrument was issued. (Ind AS 32.AG33)

In other words, the issuer:

- starts by **allocating the settlement price to the remaining liability** i.e. it determines the fair value of the remaining liability using a discount rate that is based on circumstances at the settlement date (this rate may differ from the rate used for the original allocation), and
- allocates the residual settlement amount to the equity component.

As per Ind AS 32.AG34, once the allocation of the consideration is made, any resulting gain or loss is treated in accordance with accounting principles applicable to the related component, as follows:

a) the amount of gain or loss relating to the liability component is recognised in profit or loss; and

b) the amount of consideration relating to the equity component is recognised in equity.

Illustration 33: Optionally convertible redeemable preference shares (continued from Illustration 31)

The amortisation schedule of the instrument is set out below:

Dates	*Cash flows*	*Finance cost at effective interest rate*	*Liability*	*Equity*
1July 20X1	*1,000,000*	*-*	*9,24,061*	*75,939*
30 June 20X2	*(60,000)*	*83,165*	*9,47,226*	*75,939*
30 June 20X3	*(60,000)*	*85,250*	*9,72,476*	*75,939*
30 June 20X4	*(10,60,000)*	*87,524*	*-*	*75,939*

Assume that D Ltd. has an early redemption option to prepay the instrument at ₹ 11 lakhs and on 30 June 20X3, it exercises that option. At 30 June 20X3, the interest rate has changed. At that time, D Ltd. could have issued a one-year (i.e. maturity 30 June 20X4) non-convertible instrument at 5%. Calculate the value of the liability and equity components.

Solution

Ind AS 32 requires that the amount paid (of ₹ 11 lakhs) is split by the same method as is used in the initial recording. However, at 30 June 20X3, the interest rate has changed. At that time, D Ltd. could have issued a one-year (i.e. maturity 30 June 20X4) non-convertible instrument at 5%.

The split will be made as below:

Particulars	Amount (₹)
Present value of principal payable at 30 June 20X4 in one year's time (₹ 10 lakhs discounted at 5% for one year)	9,52,381
Present value of interest payable (₹ 60,000 discounted at 5% for one year)	57,142
Total liability component	10,09,523
Consideration paid	11,00,000
Residual – equity component	90,477

Accordingly, the difference between consideration allocated to liability component (₹ 10,09,523) less carrying amount of financial liability on date of redemption i.e. 30 June 20X3 (₹ 9,72,476), amounting to ₹ 37,047 is recognised in profit or loss.

The residual i.e. consideration allocated to equity component is debited to equity.

*****

An entity may amend the terms of a convertible instrument to induce early conversion, for example by offering a more favourable conversion ratio or paying other additional consideration in the event of conversion before a specified date.

The difference, at the date the terms are amended, between:

- the fair value of the consideration the holder receives on conversion of the instrument under the revised terms and

- the fair value of the consideration the holder would have received under the original terms is recognised as a loss in profit or loss.

2.6 TREASURY SHARES

If an entity reacquires its own equity instruments:

- Consideration paid for those instruments ('treasury shares') shall be deducted from equity. An entity's own equity instruments are not recognised as a financial asset regardless of the reason for which they are reacquired.
- Consideration received shall be recognised directly in equity.
- No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments

In the consolidated financial statements, consideration for treasury shares acquired and held by other members of the consolidated group, is deducted from equity.

It may be noted that when an entity holds its own equity on behalf of others, eg a financial institution holding its own equity on behalf of a client, there is an agency relationship and as a result those holdings are not included in the entity's statement of financial position.

2.7 INTEREST, DIVIDENDS, LOSSES AND GAINS

The accounting principles related to transactions arising consequent to recognition of financial instruments are summarised below (Ind AS 32.35-41):

- The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends, losses and gains relating to that instrument are recognised as income or expense in profit or loss.
  - ♦ Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss.
  - ♦ Distributions to holders of an equity instrument shall be recognised by the entity directly in equity.
- **Transaction costs:**
  - ♦ Equity transaction – accounted for as a deduction from equity to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided. The costs of an equity transaction that is abandoned are recognised as an expense.
  - ♦ Compound financial instrument – allocated to the liability and equity components of the instrument in proportion to the allocation of proceeds.

- Income tax relating to distributions to holders of an equity instrument and to transaction costs of an equity transaction shall be accounted for in accordance with Ind AS 12 Income Taxes
- Changes in the fair value of an equity instrument are not recognised in the financial statements.
- **Presentation:**
  - The amount of transaction costs accounted for as a deduction from equity in the period is disclosed separately in accordance with Ind AS 1.
  - Dividends classified as an expense may be presented in the statement of comprehensive income either with interest on other liabilities or as a separate item.
  - Gains and losses related to changes in the carrying amount of a financial liability are recognised as income or expense in profit or loss even when they relate to an instrument that includes a right to the residual interest in the assets of the entity in exchange for cash or another financial asset.

2.8 OFFSETTING A FINANCIAL ASSET AND A FINANCIAL LIABILITY

In many situations, an entity has the right to receive or pay a single net amount in relation to two or more separate financial instruments and intends to do so as well.

As per Ind AS 32.42 and Ind AS 32.AG38A, a financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position when, and only when, an entity:

a) currently has a **legally enforceable right to set off** the recognised amounts – this means that the right of set off:

   i. must not be contingent on a future event; and

   ii. must be legally enforceable in the normal course of business, in the event of default and in the event of insolvency or bankruptcy of the entity and all of the counterparties.

b) **intends** either to settle on a net basis, or to realise the asset and settle the liability simultaneously - If an entity can settle amounts in a manner such that the outcome is, in effect, equivalent to net settlement, the entity will meet the net settlement criterion. This will occur if, and only if, the gross settlement mechanism has features that eliminate or result in insignificant credit and liquidity risk, and that will process receivables and payables in a single settlement process or cycle.

Offsetting a recognised financial asset and a recognised financial liability and presenting the net amount differs from the derecognition of a financial asset or a financial liability. Although offsetting does not give rise to recognition of a gain or loss, the derecognition of a financial instrument not only results in the removal of the previously recognised item from the statement of financial position but also may result in recognition of a gain or loss. (Ind AS 32.44).

A right of set-off is a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor. In unusual circumstances, a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor provided that there is an agreement between the three parties that clearly establishes the debtor's right of set-off. (Ind AS 32.45).

The conditions set out above are generally not satisfied and offsetting is usually inappropriate when (Ind AS 32.49):

a) several different financial instruments are used to emulate the features of a single financial instrument (a 'synthetic instrument') - For example, a floating rate long-term debt combined with an interest rate swap that involves receiving floating payments and making fixed payments synthesises a fixed rate long-term debt:

   i. Each of the individual financial instruments that together constitute a 'synthetic instrument' represents a contractual right or obligation with its own terms and conditions

   ii. Each may be transferred or settled separately.

   iii. Each financial instrument is exposed to risks that may differ from the risks to which other financial instruments are exposed.

   Accordingly, when one financial instrument in a 'synthetic instrument' is an asset and another is a liability, they are not offset and presented in an entity's statement of financial position on a net basis unless they meet the criteria for offsetting.

b) financial assets and financial liabilities arise from financial instruments having the same primary risk exposure (for example, assets and liabilities within a portfolio of forward contracts or other derivative instruments) but involve different counterparties;

c) financial or other assets are pledged as collateral for non-recourse financial liabilities;

d) financial assets are set aside in trust by a debtor for the purpose of discharging an obligation without those assets having been accepted by the creditor in settlement of the obligation (for example, a sinking fund arrangement); or

e) obligations incurred as a result of events giving rise to losses are expected to be recovered from a third party by virtue of a claim made under an insurance contract.

QUICK RECAP

- Classification as a financial liability or as equity depends on the substance of a financial instrument rather than its legal form. The substance depends on the instrument’s contractual rights and obligations.
- Liability classification - a financial instrument which contains a contractual obligation whereby the issuing entity is or may be required to deliver cash or another financial asset to the instrument holder

- There are certain rule-based exceptions to the basic principle for classification of an instrument as financial liability – puttable instruments and obligations arising only on liquidation
- Financial instrument containing a contingent settlement provision, under which the instrument would be classified as a financial liability on the occurrence or non-occurrence of some uncertain future event beyond the control of both the issuer and the holder – usually classified as a financial liability unless the part of the contingent settlement provision that indicates liability classification is not genuine; or the issuer can be required to settle the obligation in cash or another financial asset only in the event of liquidation of the issuer
- Instruments which may or will be settled in an entity's own equity instruments – apply "fixed for fixed" test
- Instruments with both equity and liability features are compound instruments – equity and liability components are accounted for separately ('split accounting')
- Split accounting involves first calculating the fair value of the liability component. The equity component is then determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole
- Subsequent changes in the value of the equity instruments are not recognised in the financial statements.
- The accounting implication of classification of a financial instrument as a financial liability or equity is given in table below:

Accounting aspect	Financial liability	Equity instrument
Re-measurement standard	Ind AS 109	Generally, not re-measured after initial measurement
Recognition of interest, dividends, losses and gains	Profit or loss	Retained earnings
Recognition of transaction costs	Included in calculation of effective interest rate and amortised over expected life of the instrument	Deduction from equity

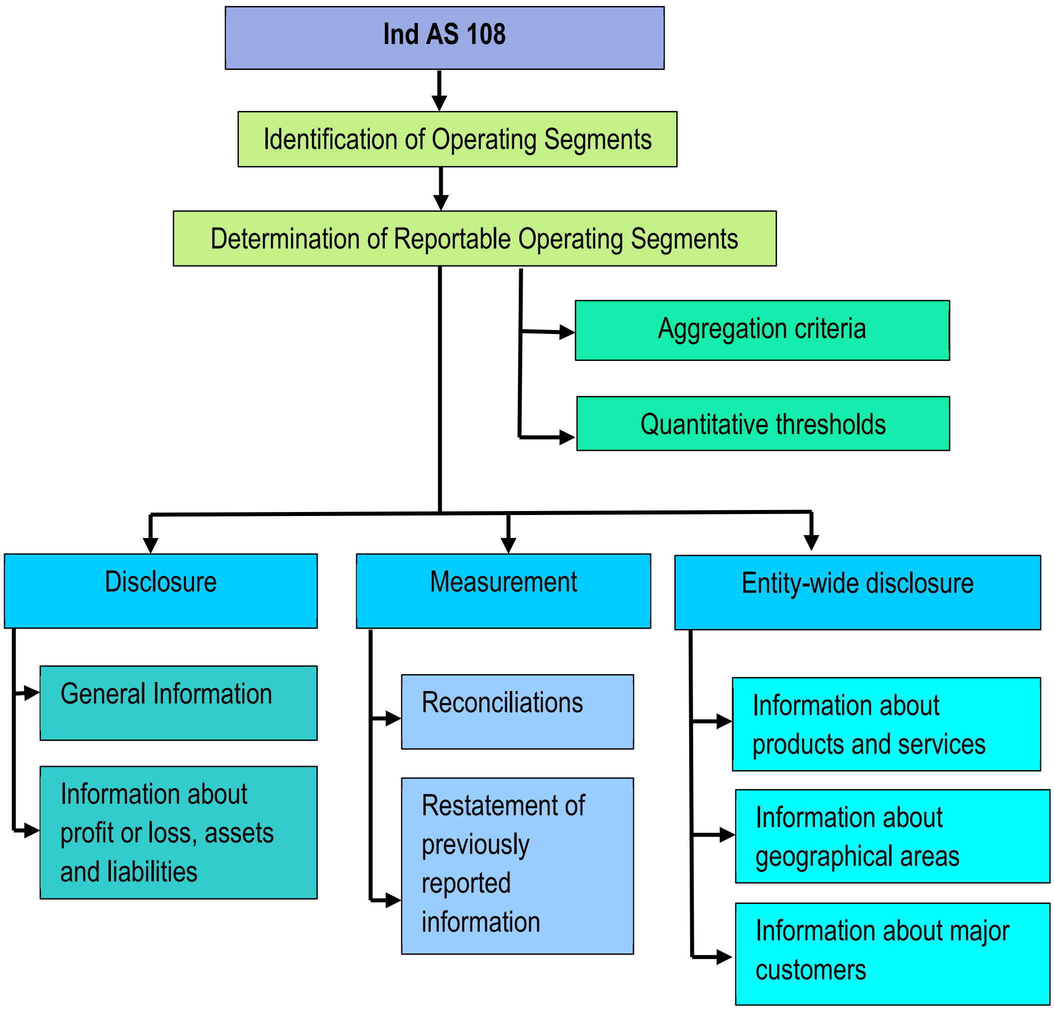
UNIT 3 : INDIAN ACCOUNTING STANDARD 108 : OPERATING SEGMENTS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Explain the meaning of ‘operating segments’
- Define the ‘chief operating decision maker’ (CODM)
- Identify the reportable segments and the application of aggregation criteria
- Comply with the disclosure requirement under Ind AS 108 with regard to operating segments
- Differentiate between Ind AS 108 vs. AS 17

UNIT OVERVIEW



3.1 CORE PRINCIPLE

An entity should disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

Ind AS 108 requires an entity to disclose information to enable the stakeholders to have insight into the entity's operations from the same perspective as that of its management. For instance, in case of an entity engaged in multiple lines of business/ business activities (e.g., engineering, financial services and IT), the users of financial statements must have the information about the performance of each of its 'business activities' as perceived by management in order to make better and more informed decisions about their investments in the entity as a whole. Similarly, an entity may be operating across multiple economic environments. 'Economic Environments' in general, are those factors which have an impact on the working of any business. These factors could include political and economic macro-systems, trade cycles, economic resources, statutory environment, income levels, industrial growth rates and many other such factors. These are dynamic in nature and are in a continuous state of change. In view of these complexities, Ind AS 108 requires disclosure of information in a manner which enables users to make informed decisions based on their assessment of the economic environments in which the different businesses of an entity operate.

3.2 SCOPE

Ind AS 108 should apply to companies to which Indian Accounting Standards notified under the Companies Act, 2013 apply.

If an entity that is not required to apply Ind AS 108 chooses to disclose information about segments that does not comply with Ind AS 108, it should not describe the information as segment information.

If a financial report contains both the consolidated financial statements of a parent that is within the scope of Ind AS 108 as well as the parent's separate financial statements, segment information is required only in the consolidated financial statements.

3.3 OPERATING SEGMENTS

An operating segment is a component of an entity:

(a) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity);

(b) whose operating results are regularly reviewed by the entity's chief operating decision maker (CODM) to make decisions about resources to be allocated to the segment and assess its performance; and

(c) for which discrete financial information is available.

An operating segment may engage in business activities for which it has yet to earn revenues, for example, start-up operations may be operating segments before earning revenues.

A perusal of the above requirements for identifying an operating segment differs with requirements contained in Accounting Standard (AS) 17, *Segment Reporting*. According to AS 17, identification of business segment is determined by considering risk and returns derived from an identical product or service or group of related products and services. Similarly, identification of geographical segment is determined by considering the risk and returns from products and services within a particular economic environment. Ind AS 108, however, requires the consideration of earning of revenues and incurring of expenses from a business activity, the operating results of which are regularly reviewed by entity's CODM. It may be noted that AS 17 follows the approach of risk and return for determination of a business and geographical segment. Ind AS 108, however, follows the management approach meaning thereby that whichever business activity is considered by the management as a separate source of revenue will be considered as an operating segment, the operating results of which are regularly reviewed by CODM to make decision about resources allocation and performance measurement.

Under this approach, not only would enterprises be likely to report more detailed information but the knowledge obtained of the structure of an enterprise's internal organisation is valuable in itself because it highlights segments based on such structure. This approach results in the following significant advantages:

- An ability to see an enterprise "through the eyes of management" enhances a user's ability to predict actions or reactions of management that can significantly affect the enterprise's prospects for future cash flows.
- Information about those segments is generated for management's use and hence the incremental cost of providing information for external reporting would be relatively low.

Illustration 1

ABC Ltd. manufactures and sells healthcare products, and food and grocery products. Three products namely A, B & C are manufactured. Product A is classified as healthcare product and product B & C are classified as food and grocery products. Products B & C are similar products. Discrete financial information is available for each manufacturing locations and for the selling activity of each product. There are two line managers responsible for manufacturing activities of products A, B & C. Manager X manages product A and Manager B manages products B & C. The operating results of health care products (product A) and food and grocery products (products B & C) are regularly reviewed by the CODM. Identify reportable segments of ABC Ltd.

Solution

In this situation both the healthcare, and food and grocery product line meet the criteria for operating segments set out above. Therefore, it is likely that ABC Ltd.'s operating segments would be classified as being (i) healthcare and (ii) food and grocery segments.

Not every part of an entity is necessarily an operating segment or part of an operating segment. For example, a corporate headquarters or some functional departments may not earn revenues or may earn revenues that are only incidental to the activities of the entity and would not be operating segments. For the purposes of Ind AS 108, an entity's post-employment benefit plans are not operating segments.

The term 'chief operating decision maker' (CODM) identifies a function, not necessarily a manager with a specific title. That function is to allocate resources to and assess the performance of the operating segments of an entity. Often the CODM of an entity is its chief executive officer or chief operating officer but, for example, it may be a group of executive directors or others.

For many entities, the three characteristics of operating segments clearly identify its operating segments. However, an entity may produce reports in which its business activities are presented in a variety of ways. If the CODM uses more than one set of segment information, other factors may identify a single set of components as constituting an entity's operating segments, including the nature of the business activities of each component, the existence of managers responsible for them, and information presented to the board of directors.

Generally, an operating segment has a segment manager who is directly accountable to and maintains regular contact with the CODM to discuss operating activities, financial results, forecasts, or plans for the segment. The term 'segment manager' identifies a function, not necessarily a manager with a specific title. The chief operating decision maker also may be the segment manager for some operating segments. A single manager may be the segment manager for more than one operating segment. If the characteristics apply to more than one set of components of an organisation but there is only one set for which segment managers are held responsible, that set of components constitutes the operating segments.

The characteristics may apply to two or more overlapping sets of components for which managers are held responsible. That structure is sometimes referred to as a matrix form of organisation. For example, in some entities, some managers are responsible for different product and service lines worldwide, whereas other managers are responsible for specific geographical areas. The CODM regularly reviews the operating results of both sets of components, and financial information is available for both. In that situation, the entity should determine which set of components constitutes the operating segments by reference to the core principle.

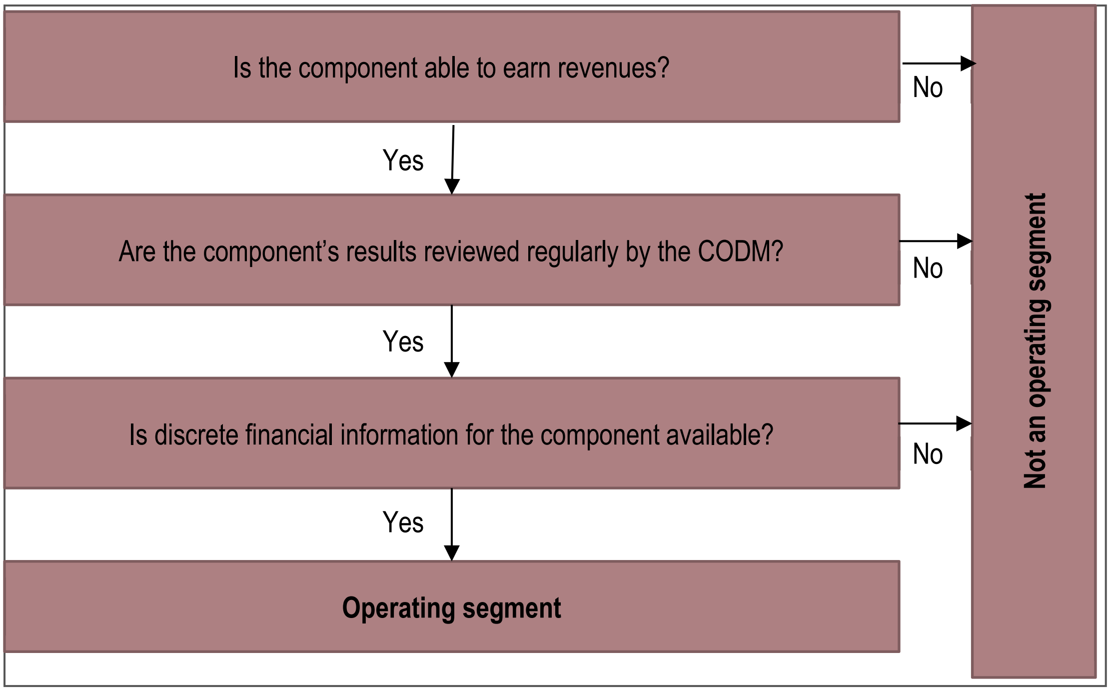


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Illustration 2

X Ltd. is engaged in the manufacture and sale of two distinct type of products A & B. X Ltd. supplies the product in the domestic market in India as well as in Singapore. There are two regional managers responsible for manufacturing activities of product A & B worldwide and also two other managers responsible for different geographical areas. For internal reporting purposes, X Ltd. provides information product-wise and as per the geographical location of the company. The CODM regularly reviews the operating results of both sets of components. How should X Ltd. identify its operating segments?

Solution

In this situation, both the geographical sales areas and product areas may meet the criteria for operating segment. However, in such situation, it is more difficult to determine clearly which set of components should be identified as the entity's operating segments. In such situation the entity should determine which set of components constitutes the operating segments by reference to the core principle. The core principle is that the entity should disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates. The entity should also assess whether the identified operating segments could realistically represent the level at which the CODM is assessing performance and allocating resources.

Therefore, X Ltd. should consider all the above factors and apply judgement to determine which component should be disclosed as operating segment.

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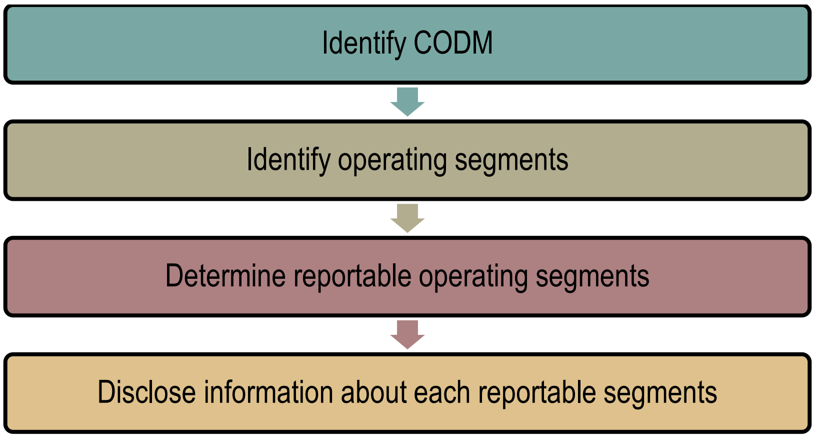
3.4 REPORTABLE SEGMENTS

An entity should report separately information about each operating segment that:

(a) has been identified or results from aggregating two or more of those segments; and

(b) exceeds the quantitative thresholds.

Standard specifies other situations in which separate information about an operating segment should be reported.



3.5 AGGREGATION CRITERIA

Operating segments often exhibit similar long-term financial performance if they have similar economic characteristics. For example, similar long-term average gross margins for two operating segments would be expected if their economic characteristics were similar. Two or more operating segments may be aggregated into a single operating segment if aggregation is consistent with the core principle of Ind AS 108, the segments have similar economic characteristics, and the segments are similar in each of the following respects:

(a) the nature of the products and services;

(b) the nature of the production processes;

(c) the type or class of customer for their products and services;

(d) the methods used to distribute their products or provide their services; and

(e) if applicable, the nature of the regulatory environment, for example, banking, insurance or public utilities.

Two or more operating segments may be aggregated into a single operating segment if

All

- aggregation is consistent with the core principle of this Ind AS
- the segments have similar economic characteristics
- the segments are similar in respect to

All

- the nature of the products and services
- the nature of the production processes
- the type or class of customer for their products and services
- the methods used to distribute their products or provide their services
- the nature of the regulatory environment, if applicable

Illustration 3

X Ltd. is engaged in the business of manufacturing and selling papers. Varieties of paper like adhesive paper, anti-rust paper, antique paper, art paper etc., are manufactured and sold by X Ltd. Should X Ltd. classify these papers into different segments?

Solution

Two or more operating segments may be aggregated into a single operating segment if the segments have similar economic characteristics, and the segments are similar with respect to various factors like nature of the product and production process, type of customers, method of distribution and regulatory requirement.

In case of X Ltd., so far as varieties of paper concerned, if all factors such as nature of the product and production process, type of customers, method of distribution and regulatory requirement are common, there is no need to create different segments for each type of paper.

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3.6 QUANTITATIVE THRESHOLDS

An entity should report separately information about an operating segment that meets any of the following quantitative thresholds:

(a) Its reported revenue, including both sales to external customers and intersegment sales or transfers, is 10% or more of the combined revenue, internal and external, of all operating segments.

(b) The absolute amount of its reported profit or loss is 10% or more of the greater, in absolute amount, of

  (i) the combined reported profit of all operating segments that did not report a loss and

  (ii) the combined reported loss of all operating segments that reported a loss.

(c) Its assets are 10% or more of the combined assets of all operating segments. Operating segments that do not meet any of the quantitative thresholds may be considered reportable and separately disclosed, if management believes that information about the segment would be useful to users of the financial statements.

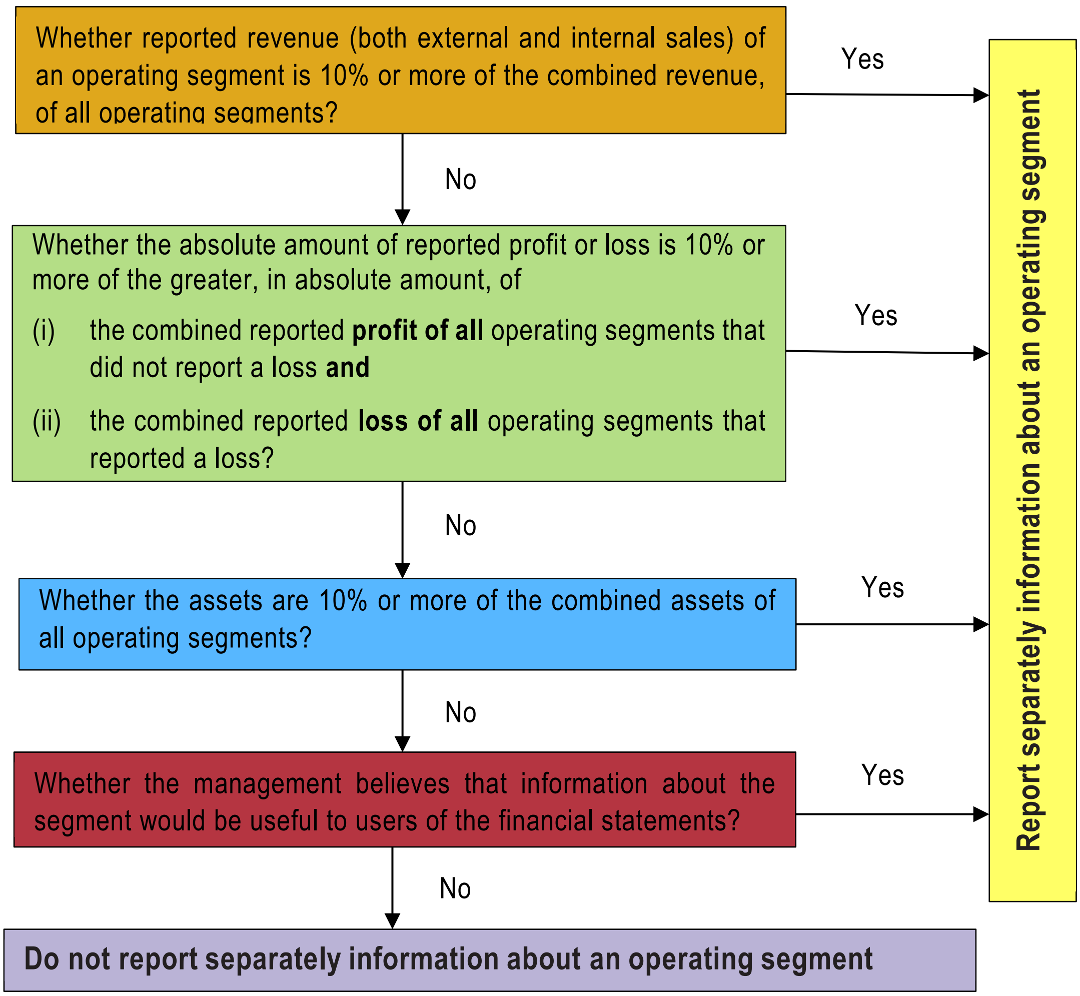

Illustration 4

X Ltd. has identified the following business components.

Segment	*Revenue (₹)*		*Profit (₹)*	*Assets (₹)*
	External	*Internal*		
Pharma	*97,00,000*	*Nil*	*20,00,000*	*55,00,000*
FMCG	*Nil*	*4,00,000*	*2,50,000*	*25,00,000*
Ayurveda	*3,00,000*	*Nil*	*2,00,000*	*4,00,000*
Others	*8,00,000*	*41,00,000*	*5,50,000*	*6,00,000*
Total for the entity	*1,08,00,000*	*45,00,000*	*30,00,000*	*90,00,000*

Which of the segments would be reportable as per the criteria prescribed in Ind AS108?

Solution

Quantitative thresholds are calculated below:

Segments	Pharma	FMCG	Ayurveda	Others
% segment sales to total sales	63.40	2.61	1.96	32.03
% segment profit to total profits	66.67	8.33	6.67	18.33
% segment assets to total assets	61.11	27.78	4.44	6.67

Segment Pharma would separately reportable since they meet all three size criteria, though any one criteria is required. FMCG segment does not satisfy the revenue and profit test but does satisfy the asset test. So it would be separately reportable. Ayurveda segment does not meet any threshold. It may not be classified as reportable segment.

An entity may combine information about operating segments that do not meet the quantitative thresholds with information about other operating segments that do not meet the quantitative thresholds to produce a reportable segment only if the operating segments have similar economic characteristics and share a majority of the aggregation criteria.

If the total external revenue reported by operating segments constitutes less than 75% of the entity's revenue, additional operating segments should be identified as reportable segments (even if they do not meet the criteria) until at least 75% of the entity's revenue is included in reportable segments.

Note

- External revenue of reportable segments must be ≥ 75% of total external revenue of the entity.
- Operating segments that do not meet any of the quantitative thresholds may be considered reportable, and separately disclosed, if information about the segment is useful to users.

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Information about other business activities and operating segments that are not reportable should be combined and disclosed in an 'all other segments' category separately from other reconciling items in the reconciliations. The sources of the revenue included in the 'all other segments' category should be described.

If management judges that an operating segment identified as a reportable segment in the immediately preceding period is of continuing significance, information about that segment should continue to be reported separately in the current period even if it no longer meets the criteria for reputability.

If an operating segment is identified as a reportable segment in the current period in accordance with the quantitative thresholds, segment data for a prior period presented for comparative purposes should be restated to reflect the newly reportable segment as a separate segment, even if that segment did not satisfy the criteria for reportability in the prior period, unless the necessary information is not available and the cost to develop it would be excessive.

There may be a practical limit to the number of reportable segments that an entity separately discloses beyond which segment information may become too detailed. Although no precise limit has been determined, as the number of segments that are reportable increases above ten, the entity should consider whether a practical limit has been reached.

3.7 DISCLOSURE

An entity should disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

An entity should disclose the following for each period for which a statement of profit and loss is presented:

(a) general information;

(b) information about reported segment profit or loss, including specified revenues and expenses included in reported segment profit or loss, segment assets, segment liabilities and the basis of measurement; and

(c) reconciliations of the totals of segment revenues, reported segment profit or loss, segment assets, segment liabilities and other material segment items to corresponding entity amounts.

Reconciliations of the amounts in the balance sheet for reportable segments to the amounts in the entity's balance sheet are required for each date at which a balance sheet is presented. Information for prior periods should be restated.

3.7.1 General Information

An entity should disclose the following general information:

(a) factors used to identify the entity's reportable segments, including the basis of organisation (for example, whether management has chosen to organise the entity around differences in products and services, geographical areas, regulatory environments, or a combination of factors and whether operating segments have been aggregated); and

(b) the judgements made by management in applying the aggregation criteria. This includes a brief description of the operating segments that have been aggregated in this way and the economic indicators that have been assessed in determining that the aggregated operating segments share similar economic characteristics; and

(c) types of products and services from which each reportable segment derives its revenues.

The following illustrates the disclosure of descriptive information about an entity's reportable segments :

3.7.1.1 Factors that management used to identify the entity's reportablesegments

Diversified Company's reportable segments are strategic business units that offer different products and services. They are managed separately because each business requires different technology and marketing strategies. Most of the businesses were acquired as individual units, and the management at the time of the acquisition was retained.

3.7.1.2 Description of the types of products and services from which each reportable segment derives its revenues

Diversified Company has five reportable segments: car parts, motor vessels, software, electronics and finance. The car parts segment produces replacement parts for sale to car parts retailers. The motor vessels segment produces small motor vessels to serve the offshore oil industry and similar businesses. The software segment produces application software for sale to computer manufacturers and retailers. The electronics segment produces integrated circuits and related products for sale to computer manufacturers. The finance segment is responsible for portions of the company's financial operations including financing customer purchases of products from other segments and property lending operations.

3.7.2 Information about profit or loss, assets and liabilities

An entity should report a measure of profit or loss for each reportable segment. An entity should report a measure of total assets and liabilities for each reportable segment if such amounts are regularly provided to the CODM. An entity should also disclose the following about each reportable segment if the specified amounts are included in the measure of segment profit or loss reviewed by the CODM, or are otherwise regularly provided to the CODM, even if not included in that measure of segment profit or loss:

(a) revenues from external customers;

(b) revenues from transactions with other operating segments of the same entity;

(c) interest revenue;

(d) interest expense;

(e) depreciation and amortisation;

(f) material items of income and expense disclosed in accordance with Ind AS 1, *Presentation of Financial Statements*;

(g) the entity's interest in the profit or loss of associates and joint ventures accounted for by the equity method;

(h) income tax expense or income; and

(i) material non-cash items other than depreciation and amortisation.

An entity should report interest revenue separately from interest expense for each reportable segment unless a majority of the segment's revenues are from interest and the CODM relies primarily on net interest revenue to assess the performance of the segment and make decisions about resources to be allocated to the segment. In that situation, an entity may report that segment's interest revenue net of its interest expense and disclose that it has done so.

An entity should disclose the following about each reportable segment if the specified amounts are included in the measure of segment assets reviewed by the CODM or are otherwise regularly provided to the CODM, even if not included in the measure of segment assets:

(a) the amount of investment in associates and joint ventures accounted for by the equity method; and

(b) the amounts of additions to non-current assets (For assets classified according to a liquidity presentation, non-current assets are assets that include amounts expected to be recovered more than twelve months after the reporting period) other than financial instruments, deferred tax assets, net defined benefit assets (in accordance with Ind AS 19, *Employee Benefits*) and rights arising under insurance contracts.

The following table illustrates a suggested format for disclosing information about segment profit or loss, assets and liabilities. The same type of information is required for each year for which a statement of profit and loss is presented. Diversified Company does not allocate tax expense (tax income) or non-recurring gains and losses to reportable segments. In addition, not all reportable segments have material non-cash items other than depreciation and amortisation in profit or loss. The amounts in this illustration are assumed to be the amounts in reports used by the CODM.

Information about reportable segment profit or loss, assets and liabilities

	Car parts ₹	Motor vessels ₹	Software ₹	Electronics ₹	Finance ₹	All others ₹	Total ₹
Revenue from external customers	3,000	5,000	9,500	12,000	5,000	1,000[(a)]	35,500
Inter-segment revenues	-	-	3,000	1,500	-	-	4,500
Interest revenue	450	800	1,000	1,500	-	-	3,750
Interest expense	350	600	700	1,100	-	-	2,750
Net interest revenue[(b)]	-	-	-				1,000
Depreciation and amortisation	200	100	50	1,500	1,100	-	2,950

Reportable Segment profit	200	70	900	2,300	500	100	4,070
Other material Non-cash item:							
Impairment of assets	-	200	-	-	-	-	200
Reportable segment assets	2,000	5,000	3,000	12,000	57,000	2,000	81,000
Expenditures for reportable segment non-current assets	300	700	500	800	600	-	2,900
Reportable segment liabilities	1,050	3,000	1,800	8,000	30,000		43,850

(a) Revenues from segments below the quantitative thresholds are attributable to four operating segments of Diversified Company. Those segments include a small property business, an electronics equipment rental business, a software consulting practice and a warehouse leasing operation. None of those segments has ever met any of the quantitative thresholds for determining reportable segments.

(b) The finance segment derives a majority of its revenue from interest. Management primarily relies on net interest revenue, not the gross revenue and expense amounts, in managing that segment. Therefore, only the net amount is disclosed.

3.8 MEASUREMENT

The amount of each segment item reported should be the measure reported to the CODM for the purposes of making decisions about allocating resources to the segment and assessing its performance. Adjustments and eliminations made in preparing an entity's financial statements and allocations of revenues, expenses, and gains or losses should be included in determining reported segment profit or loss only if they are included in the measure of the segment's profit or loss that is used by the chief operating decision maker. Similarly, only those assets and liabilities that are included in the measures of the segment's assets and segment's liabilities that are used by the chief operating decision maker should be reported for that segment. If amounts are allocated to reported segment profit or loss, assets or liabilities, those amounts should be allocated on a reasonable basis.

If the CODM uses only one measure of an operating segment's profit or loss, the segment's assets or the segment's liabilities in assessing segment performance and deciding how to allocate resources, segment profit or loss, assets and liabilities should be reported at those measures. If the CODM uses more than one measure of an operating segment's profit or loss, the segment's assets or the segment's liabilities, the reported measures should be those that management believes are determined in accordance with the measurement principles most consistent with those used in measuring the corresponding amounts in the entity's financial statements.

An entity should provide an explanation of the measurements of segment profit or loss, segment assets and segment liabilities for each reportable segment. At a minimum, an entity should disclose the following:

(a) the basis of accounting for any transactions between reportable segments;

(b) the nature of any differences between the measurements of the reportable segments' profits or losses and the entity's profit or loss before income tax expense or income and discontinued operations (if not apparent from the reconciliations). Those differences could include accounting policies and policies or allocation of centrally incurred costs that are necessary for an understanding of the reported segment information;

(c) the nature of any differences between the measurements of the reportable segments' assets and the entity's assets (if not apparent from the reconciliations. Those differences could include accounting policies and policies for allocation of jointly used assets that are necessary for an understanding of the reported segment information;

(d) the nature of any differences between the measurements of the reportable segments' liabilities and the entity's liabilities (if not apparent from the reconciliations. Those differences could include accounting policies and policies for allocation of jointly utilised liabilities that are necessary for an understanding of the reported segment information;

(e) the nature of any changes from prior periods in the measurement methods used to determine reported segment profit or loss and the effect, if any, of those changes on the measure of segment profit or loss; and

(f) the nature and effect of any asymmetrical allocations to reportable segments. For example, an entity might allocate depreciation expense to a segment without allocating the related depreciable assets to that segment.

Measurement of operating segment profit or loss, assets and liabilities

The accounting policies of the operating segments are the same as those described in the significant accounting policies except that pension expense for each operating segment is recognised and measured on the basis of cash payments to the pension plan. Diversified Company evaluates performance on the basis of profit or loss from operations before tax expense not including non-recurring gains and losses and foreign exchange gains and losses.

Diversified Company accounts for intersegment sales and transfers as if the sales or transfers were to third parties, i.e., at current market prices.

3.8.1 Reconciliations

An entity should provide reconciliations of all of the following:

(a) the total of the reportable segments' revenues to the entity's revenue;

(b) the total of the reportable segments' measures of profit or loss to the entity's profit or loss before tax expense (tax income) and discontinued operations. However, if an entity allocates to reportable segments items such as tax expense (tax income), the entity may reconcile the total of the segments' measures of profit or loss to the entity's profit or loss after those items;

(c) the total of the reportable segments' assets to the entity's assets if the segment assets are reported;

(d) the total of the reportable segments' liabilities to the entity's liabilities if segment liabilities are reported; and

(e) the total of the reportable segments' amounts for every other material item of information disclosed to the corresponding amount for the entity.

All material reconciling items should be separately identified and described. For example, the amount of each material adjustment needed to reconcile reportable segment profit or loss to the entity's profit or loss arising from different accounting policies should be separately identified and described.

The following illustrate reconciliations of reportable segment revenues, profit or loss, assets and liabilities to the entity's corresponding amounts. Reconciliations also are required to be shown for every other material item of information disclosed. The entity's financial statements are assumed not to include discontinued operations. The entity recognises and measures pension expense of its reportable segments on the basis of cash payments to the pension plan, and it does not allocate certain items to its reportable segments.

Reconciliation of reportable segment revenues, profit or loss, assets and liabilities

Revenues	**₹**
Total revenues for reportable segments	39,000
Other revenues	1,000
Elimination of intersegment revenues	(4,500)
Entity's revenues	35,500
Profit or Loss	**₹**
Total profit or loss for reportable segments	3,970
Other profit or loss	100
Elimination of intersegment profits	(500)
Unallocated amounts:	
Litigation settlement received	500
Other corporate expenses	(750)
Adjustment to pension expense in consolidation	(250)
Income before income tax expense	3,070
Assets	**₹**
Total assets for reportable segments	79,000
Other assets	2,000
Elimination of receivable from corporate headquarters	(1,000)
Other unallocated amounts	1,500
Entity's assets	81,500

Liabilities	**₹**
Total liabilities for reportable segments	43,850
Unallocated defined benefit pension liabilities	25,000
Entity's liabilities	68,850

Other material items	**Reportable Segment totals ₹**	**Adjustments ₹**	**Entity totals ₹**
Interest revenue	3,750	75	3,825
Interest expenses	2,750	(50)	2,700
Net interest revenue (finance segment only)	1,000	-	1,000
Expenditure for assets	2,900	1,000	3,900
Depreciation and amortisation	2,950	-	2,950
Impairment of assets	200	-	200

The reconciling item to adjust expenditures for assets is the amount incurred for the corporate headquarters building, which is not included in segment information. None of the other adjustments are material.

3.9 RESTATEMENT OF PREVIOUSLY REPORTED INFORMATION

If an entity changes the structure of its internal organisation in a manner that causes the composition of its reportable segments to change, the corresponding information for earlier periods, including interim periods, should be restated unless the information is not available and the cost to develop it would be excessive. The determination of whether the information is not available and the cost to develop it would be excessive should be made for each individual item of disclosure. Following a change in the composition of its reportable segments, an entity should disclose whether it has restated the corresponding items of segment information for earlier periods.

If an entity has changed the structure of its internal organisation in a manner that causes the composition of its reportable segments to change and if segment information for earlier periods, including interim periods, is not restated to reflect the change, the entity should disclose in the year in which the change occurs segment information for the current period on both the old basis and the new basis of segmentation, unless the necessary information is not available and the cost to develop it would be excessive.

3.10 ENTITY-WIDE DISCLOSURES

Some entities' business activities are not organised on the basis of differences in related products and services or differences in geographical areas of operations. Such an entity's reportable segments may report revenues from a broad range of essentially different products and services, or more than one of its reportable segments may provide essentially the same products and services. Similarly, an entity's reportable segments may hold assets in different geographical areas and report revenues from customers in different geographical areas, or more than one of its reportable segments may operate in the same geographical area. Certain information required should be provided only if it is not provided as part of the reportable segment information required by Ind AS 108.

3.10.1 Information about products and services

An entity should report the revenues from external customers for each product and service, or each group of similar products and services, unless the necessary information is not available and the cost to develop it would be excessive, in which case that fact should be disclosed. The amounts of revenues reported should be based on the financial information used to produce the entity's financial statements.

3.10.2 Information about geographical areas

An entity should report the following geographical information, unless the necessary information is not available and the cost to develop it would be excessive:

(a) revenues from external customers

(i) attributed to the entity's country of domicile and

(ii) attributed to all foreign countries in total from which the entity derives revenues. If revenues from external customers attributed to an individual foreign country are material, those revenues should be disclosed separately. An entity should disclose the basis for attributing revenues from external customers to individual countries; and

(b) non-current assets (For assets classified according to a liquidity presentation, non-current assets are assets that include amounts expected to be recovered more than twelve months after the reporting period) other than financial instruments, deferred tax assets, post- employment benefit assets, and rights arising under insurance contracts (i) located in the entity's country of domicile and (ii) located in all foreign countries in total in which the entity holds assets. If assets in an individual foreign country are material, those assets should be disclosed separately.

The amounts reported should be based on the financial information that is used to produce the entity's financial statements. If the necessary information is not available and the cost to develop it would be excessive, that fact should be disclosed. An entity may provide, in addition to the information required by this paragraph, subtotals of geographical information about groups of countries.

The following illustrates the geographical information required (Because Diversified Company's reportable segments are based on differences in products and services, no additional disclosures of revenue information about products and services are required.)

Geographical Information	Revenue[(a)] ₹	Non-Current Assets ₹
United States	19,000	11,000
Canada	4,200	-
China	3,400	6,500
Japan	2,900	3,500
Other countries	6,000	3,000
Total	35,500	24,000

[(a)] Revenue are attributed to countries on the basis of the customer's location.

3.10.3 Information about major customers

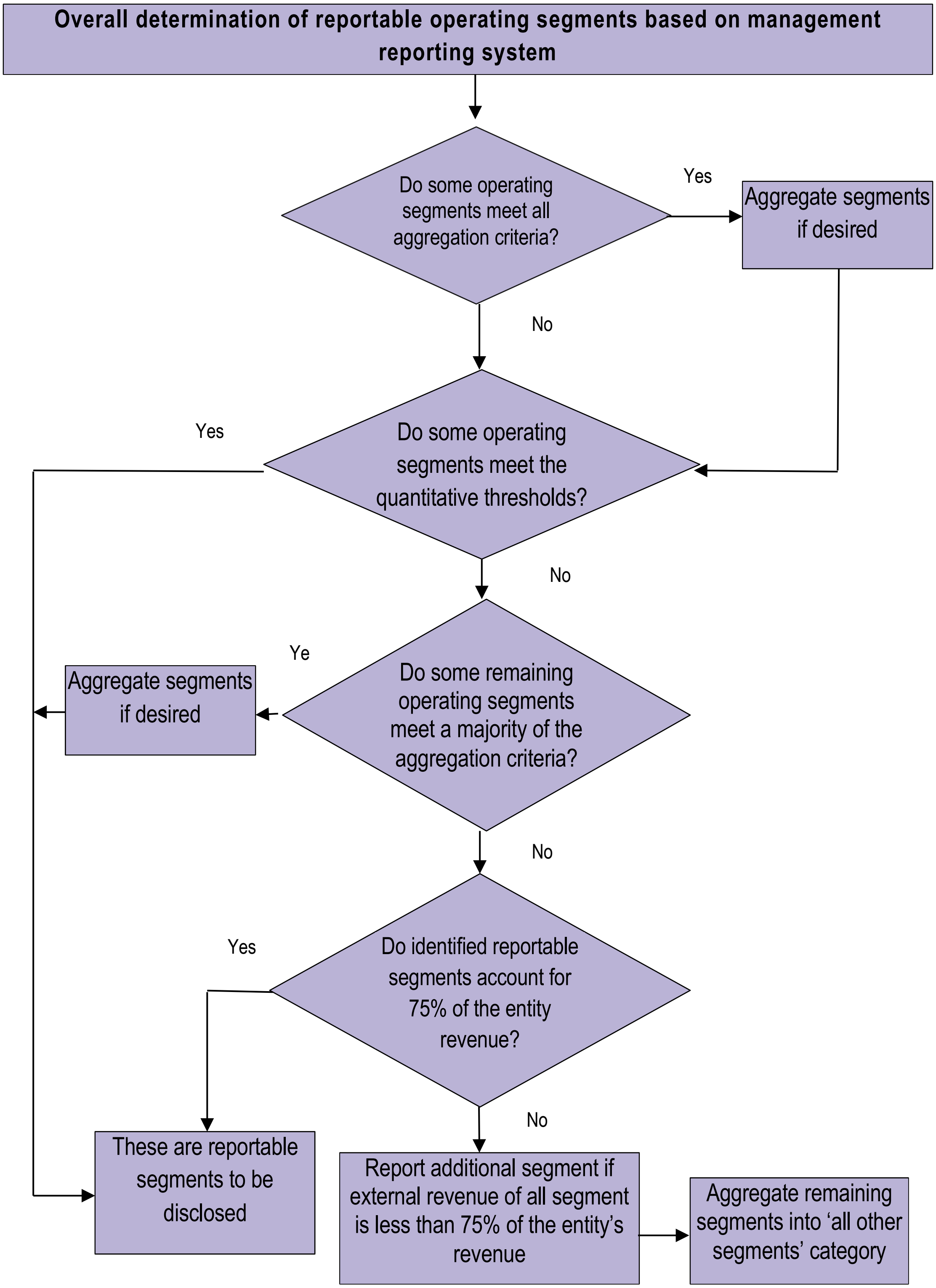
An entity should provide information about the extent of its reliance on its major customers. If revenues from transactions with a single external customer amount to 10% or more of an entity's revenues, the entity should disclose that fact, the total amount of revenues from each such customer, and the identity of the segment or segments reporting the revenues. The entity need not disclose the identity of a major customer or the amount of revenues that each segment reports from that customer. For the purposes of Ind AS 108, a group of entities known to a reporting entity to be under common control should be considered a single customer. However, judgement is required to assess whether a government (including government agencies and similar bodies whether local, national or international) and entities known to the reporting entity to be under the control of that government are considered a single customer. In assessing this, the reporting entity should consider the extent of economic integration between those entities.

The following illustrates the information about major customers. Neither the identity of the customer nor the amount of revenues for each operating segment is required.

Revenues from one customer of Diversified Company's software and electronics segments represent approximately ₹ 5,000 of the Company's total revenues.

Diagram to assist in identifying reportable segments

The following diagram illustrates how to apply the main provisions for identifying reportable segments as defined in Ind AS 108.


Overall determination of reportable operating segments based on management reporting system
Do some operating segments meet all aggregation criteria?
Yes
Aggregate segments if desired
No
Do some operating segments meet the quantitative thresholds?
Yes
No
Do some remaining operating segments meet a majority of the aggregation criteria?
Ye
Aggregate segments if desired
No
Do identified reportable segments account for 75% of the entity revenue?
Yes
These are reportable segments to be disclosed
No
Report additional segment if external revenue of all segment is less than 75% of the entity's revenue
Aggregate remaining segments into 'all other segments' category

3.11 SIGNIFICANT DIFFERENCES BETWEEN IND AS 108 AND AS 17

S. No.	Particulars	Ind AS 108	AS 17
1.	*Scope*	Ind AS 108 is applicable to companies which are covered under Ind AS in accordance with the Companies Act, 2013 and related rules.	AS 17 is applicable to non-SMCs.
2.	*Determination of segments*	Segments are identified based on how the financial information is regularly reviewed by the CODM.	AS 17 requires an entity to identify two types of segments-business and geographical, using a risk and rewards approach.
3.	*Measurement*	• Same measurement basis as used by CODM-reconciliation to financial statements needed. • Terms such as segment assets, Segment revenue, segment asset and segment liability are not defined.	• Measurement basis in conformity with financial statements. • Segment revenue, segment expense, segment result, segment asset and segment liability have been defined.
4.	*Aggregation criteria*	Ind AS 108 requires an entity to aggregate segments with similar economic characteristics.	No specific guidance under AS 17
5.	*Entity wide disclosures*	Entity wide disclosures regarding information about products and services, information about geographical areas, information about major customers are required- this would equally apply to entities having a single reportable segment.	Disclosures required based on classification of segments as primary or secondary.

TEST YOUR KNOWLEDGE

Questions

1. X Ltd. has identified 4 operating segments for which revenue data is given below:

	External Sale (₹)	Internal Sale (₹)	Total (₹)
Segment A	30,00,000	Nil	30,00,000
Segment B	6,50,000	Nil	6,50,000
Segment C	8,50,000	1,00,000	9,50,000
Segment D	5,00,000	49,00,000	54,00,000
Total Sales	**50,00,000**	**50,00,000**	**1,00,00,000**

Additional information:

Segment C is a new business unit and management expect this segment to make a significant contribution to external revenue in coming years.

Which of the segments would be reportable under the criteria identified in Ind AS 108?

2. X Ltd. is operating in coating industry. Its business segment comprise coating and others consisting of chemicals, polymers and related activities. Certain information for financial year 20X1-20X2 is given below:

(₹ in lakhs)

Segments	External sale	Tax	Other operating income	Result	Asset	Liabilities
Coating	2,00,000	5,000	40,000	10,000	50,000	30,000
Others	70,000	3,000	15,000	4,000	30,000	10,000

Additional information:

1. Unallocated revenue net of expenses is ₹ 30,00,00,000
2. Interest and bank charges is ₹ 20,00,00,000
3. Income tax expenses is ₹ 20,00,00,000 (current tax ₹ 19,50,00,000 and deferred tax ₹ 50,00,000)
4. Investments ₹ 1,00,00,00,000 and unallocated assets ₹ 1,00,00,00,000.
5. Unallocated liabilities, Reserve & surplus and share capital are ₹ 2,00,00,00,000, ₹ 3,00,00,00,000 & ₹ 1,00,00,00,000 respectively.
6. Depreciation amounts for coating & others are ₹ 10,00,00,000 and ₹ 3,00,00,000 respectively.

7. Capital expenditure for coating and others are ₹ 50,00,00,000 and ₹ 20,00,00,000 respectively.

8. Revenue from outside India is ₹ 3,00,00,00,000 and segment asset outside India ₹ 1,00,00,00,000.

Based on the above information, how X Ltd. would disclose information about reportable segment revenue, profit or loss, assets and liabilities for financial year 20X1-20X2?

Answers

1. Threshold amount is ₹ 10,00,000 (₹ 1,00,00,000 × 10%).

Segment A exceeds the quantitative threshold (₹ 30,00,000 > ₹ 10,00,000) and hence reportable segment.

Segment D exceeds the quantitative threshold (₹ 54,00,000 > ₹ 10,00,000) and hence reportable segment.

Segment B & C do not meet the quantitative threshold amount and may not be classified as reportable segment.

However, the total external revenue generated by these two segments A & D represent only 70% (₹ 35,000/50,000 x 100) of the entity's total external revenue. If the total external revenue reported by operating segments constitutes less than 75% of the entity total external revenue, additional operating segments should be identified as reportable segments until at least 75% of the revenue is included in reportable segments.

In case of X Ltd., it is given that Segment C is a new business unit and management expect this segment to make a significant contribution to external revenue in coming years. In accordance with the requirement of Ind AS 108, X Ltd. designates this start-up segment C as a reportable segment, making the total external revenue attributable to reportable segments 87% (₹ 43,50,000/ 50,00,000 x 100) of total entity revenues.

2. Segment information

(A) Information about operating segment

(1) the company's operating segments comprise:

Coatings: consisting of decorative, automotive, industrial paints and related activities. Others: consisting of chemicals, polymers and related activities.

(2) Segment revenues, results and other information.

(₹ in Lakhs)

	Revenue	Coating	Others	Total
1.	External sales (gross)	2,00,000	70,000	2,70,000

	Tax	(5,000)	(3,000)	(8,000)
	External sales (net)	1,95,000	67,000	2,62,000
	Other operating income	40,000	15,000	55,000
	Total Revenue	2,35,000	82,000	3,17,000
2.	**Results**			
	Segment results	10,000	4,000	14,000
	Unallocated income (net of unallocated expenses)			3,000
	Profit from operation before interest, taxation and exceptional items			**17,000**
	Interest and bank charges			(2,000)
	Profit before exceptional items			**15,000**
	Exceptional items			Nil
	Profit before taxation			**15,000**
	Income Taxes			
	-Current taxes			1,950
	-Deferred taxes			(50)
	Profit after taxation			**13,000**
3.	**Other Information**			
(a)	**Assets**			
	Segment Assets	50,000	30,000	80,000
	Investments			10,000
	Unallocated assets			10,000
	Total Assets			**1,00,000**
(b)	**Liabilities/Shareholder's funds**			
	Segment liabilities	30,000	10,000	40,000
	Unallocated liabilities			20,000
	Share capital			10,000
	Reserves and surplus			30,000
	Total liabilities/shareholder's funds			**1,00,000**

(c)	**Others**			
	Capital Expenditure		5,000	2,000
	Depreciation		1,000	300
Geographical Information				**(₹ in lakhs)**
		India (₹)	**Outside India (₹)**	**Total (₹)**
	Revenue	2,87,000	30,000	3,17,000
	Segment assets	70,000	10,000	80,000
	Capital expenditure	7,000		7,000

Notes:

(i) The operating segments have been identified in line with the Ind AS 108, taking into account the nature of product, organisation structure, economic environment and internal reporting system.

(ii) Segment revenue, results, assets and liabilities include the respective amounts identifiable to each of the segments. Unallocable assets include unallocable fixed assets and other current assets. Unallocable liabilities include unallocable current liabilities and net deferred tax liability.

(iii) Corresponding figures for previous year have not been provided. However, in practical scenario the corresponding figures would need to be given.

CHAPTER 12

ACCOUNTING AND REPORTING OF FINANCIAL INSTRUMENTS

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ❑ Definition of financial asset, financial liability and equity
- ❑ Examine the scope of financial instruments and items excluded from scope of financial instruments
- ❑ Understand the application of these definitions and scope to different forms of instruments
- ❑ Determine whether the financial instruments such as preference shares, debentures and bonds will be classified under "equity" or "financial liabilities" or components thereof will be classified under both
- ❑ Apply necessary accounting principles for determining when a financial liability can be offset with a financial asset.
- ❑ Classify financial asset and financial liability
- ❑ Measure financial assets at initial and subsequent date
- ❑ Measure financial liability at initial and subsequent date
- ❑ Reclassify the financial instrument and deal with the accounting aspect upon reclassification
- ❑ Apply accounting principles for recognition of financial assets and financial liabilities

- Determine the accounting treatment for regular way purchase or sale of financial assets
- Determine whether or not a transfer qualifies for derecognition and accounting treatment in various situations
- Apply accounting principles for derecognition of financial liabilities, including evaluating practical complexities involved in exchange of financial instruments or parts thereof
- Acquire the conceptual understanding of "derivatives" and "embedded derivatives",
- Identify the situations in which embedded derivatives need to be separated and
- Deal with the Accounting principles in the situations in which embedded derivatives are so separated.
- Disclosure necessary details regarding financial instruments as per the standards
- Identify the hedged items
- Designate the items as hedged items/instruments
- Qualify instruments for hedge accounting
- Determine the criteria for qualifying the items as hedge items and its accounting.

CHAPTER OVERVIEW

The chapter is divided into 7 units-

a) **Unit 1 'Financial Instruments: Scope and Definitions'** deals with a brief introduction of financial instruments, definitions of financial instrument, financial asset, financial liability and equity instrument. It also discusses the contracts which are included and excluded from the scope of the standards on Financial Instruments.

b) **Unit 2 'Financial Instruments: Equity and Financial Liabilities'** covers the analysis of the definition of financial liabilities and equity. It also deliberates critical features in differentiating a financial liability from an equity instrument and delves into various aspects which help in determining the liability as financial liability. The unit also explains when an instrument is a compound financial instrument. It also analysis treasury shares, interest, dividends, losses and gains. Finally, it elucidates offsetting a financial asset and financial liability.

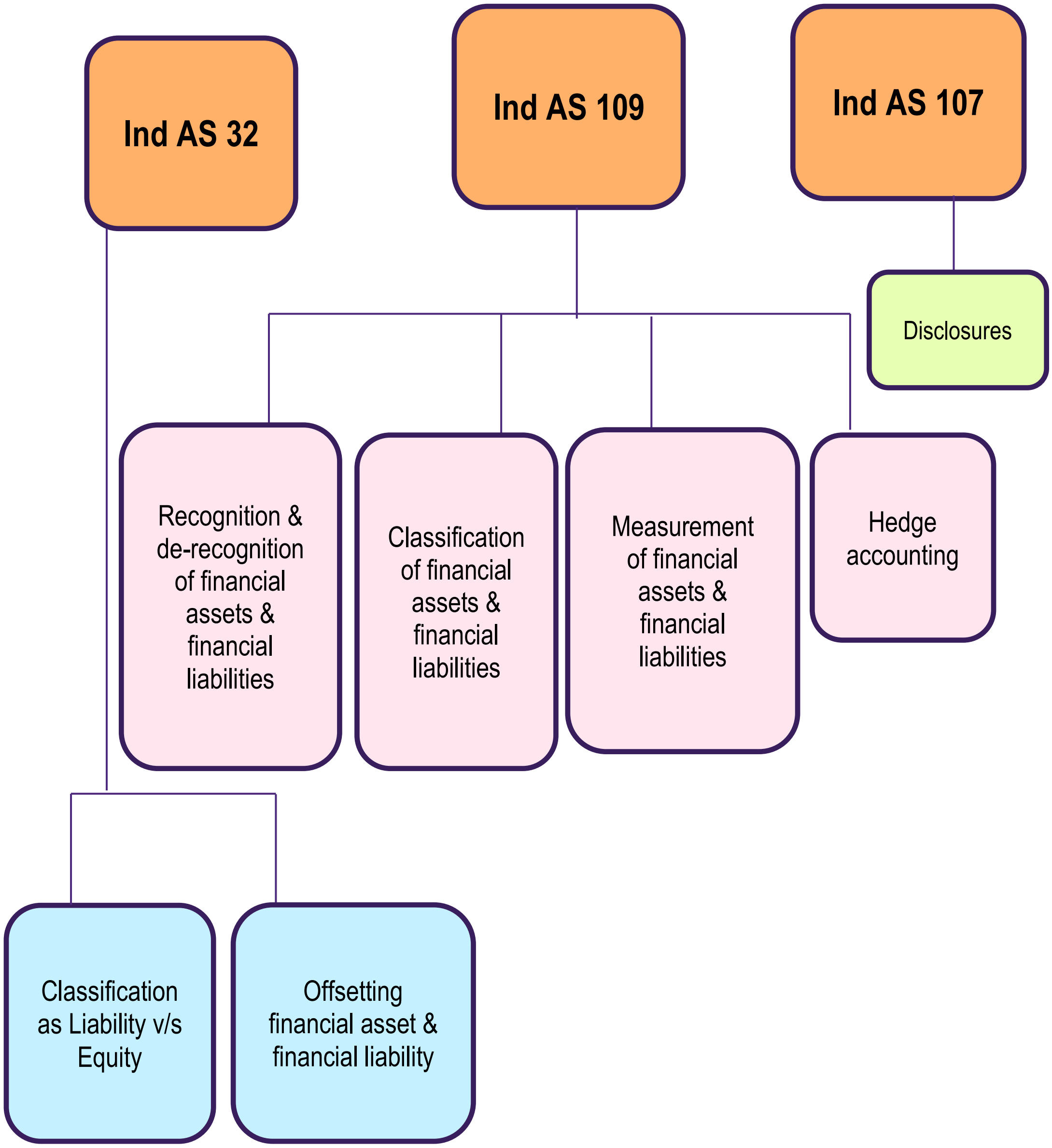
c) **Unit 3 'Classification and Measurement of Financial Assets and Financial Liabilities'**, deals with criterias for classification, measurement (at initial and subsequent dates), reclassification of financial assets and financial liabilities. It further contains discussions on impairment of financial assets.

d) **Unit 4 'Recognition and Derecognition of Financial Instruments'** covers guidance prescribed in the standard on initial recognition of financial instruments. It also takes into account, the timings of recognition and accounting treatment under various situations. Later on, it discusses the derecognition of financial instruments and situations under which derecognition will be considered or not considered. The unit also enumerates the extinguishment and modification of financial liabilities and accounting for debt for equity swaps.

e) **Unit 5 'Derivatives and Embedded Derivatives'** defines the two derivatives with examples and the manner of separating the embedded derivatives from the host contract alongwith the characteristics differences and deals with the accounting thereof.

f) **Unit 6 'Disclosures'** covers disclosure compliance as stated in the standard under Balance Sheet, Statement of Profit and Loss and at other places.

g) **Unit 7 'Hedge Accounting'** is based on identification and designation of hedge items, criterias qualifying an item as hedge item and accounting thereof.


Ind AS 32
Ind AS 109
Ind AS 107
Disclosures
Recognition & de-recognition of financial assets & financial liabilities
Classification of financial assets & financial liabilities
Measurement of financial assets & financial liabilities
Hedge accounting
Classification as Liability v/s Equity
Offsetting financial asset & financial liability

UNIT 1: FINANCIAL INSTRUMENTS: SCOPE AND DEFINITIONS

1.1 INTRODUCTION

With the changing landscape of Indian economy and more liberalisation, raising funds in national and internal markets through different forms of instruments has gathered momentum. As companies expand their horizon, investors at the same time are getting cautious to invest through different means to achieve their intended objective, which could have fixed return like a debt instrument or a residual share in net assets like equity or both. Several type of instruments are issued like convertible preference shares, FCCBs, foreign currency loans, debt syndication arrangements, loans from group companies, etc. by borrowing entities for raising funds. Accounting treatment of these instruments in the books, with introduction of Indian Accounting Standards (Ind AS) is important for us to understand to reflect the right accounting for users of financial statements.

Under erstwhile Indian GAAP, there was no guidance on financial instruments except for Accounting Standard (AS) 13 'Accounting for Investments' and guidance on derivative contracts accounting incorporated in AS 11 'The Effects of Changes in Foreign Exchange Rates'.

In order to cope up with rising complexity of type of instruments being issued, the Institute of Chartered Accountants of India ("ICAI") earlier issued AS 30 'Financial Instruments: Recognition and Measurement', AS 31 'Financial Instruments: Presentation' and AS 32 'Financial Instruments: Disclosures' in the year 2009. These accounting standards were developed based on the guidance in International Financial Reporting Standards ("IFRS") but were not made mandatory. Earlier it was proposed to be made mandatory for Level I Corporate Entities. However, these AS were withdrawn in the year 2016 since it was not notified by the Ministry of Corporate Affairs (MCA). Infact meanwhile, MCA notified Ind AS including Ind AS on Financial Instruments in the year 2015 and made them applicable for Level I corporate entities.

MCA notified following Ind AS to deal with accounting of financial instruments:

- Ind AS 109 – Financial instruments
- Ind AS 32 – Financial instruments: Presentation
- Ind AS 107 – Financial Instruments: Disclosures

These Ind AS are largely aligned with the prevailing guidance in IFRS which require classification of a financial instrument based on substance of the arrangement between the parties rather than their legal form. Further, recognition and measurement criteria are also driven based on classification of such instruments.

1.2 WHAT ARE FINANCIAL INSTRUMENTS?

A **financial instrument** is any **contract** that gives rise to a **financial asset** of one entity and a **financial liability** or **equity instrument** of another entity.

- Here, a ***contract*** refers to an agreement between two or more parties that has clear economic consequences and which parties usually are bound to adhere, usually because the agreement may be enforceable by law.
- Contracts need not be in writing and may take a variety of forms.
- An important point to note is any assets or liabilities that are not contractual are not financial liabilities or financial assets. For eg.: income taxes are a statutory obligation and not arising from contract, constructive obligations as defined in Ind AS 37 – Provisions, Contingent Liabilities and Contingent Assets do not arise from contracts and hence, are not financial liabilities, etc.

On the basis of the above definition, a financial instrument can be either of the following –

Financial asset

Common examples

- ❖ Cash
- ❖ Trade receivables
- ❖ Investments in bonds and deposits
- ❖ Investment in equity instruments
- ❖ Loans receivable, etc.

or

Financial liability

Common examples

- ❖ Loans and borrowings
- ❖ Payables for purchase of goods & services
- ❖ Finance lease liabilities
- ❖ Redeemable instruments like preference shares, debentures, etc.
- ❖ Guarantee given for repayment of debt upon borrower's default

or

Equity	
	❖ Equity instruments issued ❖ Warrants to issue fixed number of shares at fixed price against each warrant ❖ Other instruments convertible into fixed number of equity shares, etc.

- Financial instruments include primary instruments (such as receivables, payables and equity instruments) and derivative financial instruments (such as financial options, futures and forwards, interest rate swaps and currency swaps).

  While the examples above provide an indication of what financial instruments comprise, let's understand the definition of each of these type of financial instruments in greater detail.

1.3 WHAT IS A FINANCIAL ASSET?

A **'financial asset'** is any asset that is:

(a) **Cash**;

(b) An equity instrument of another entity;

(c) A **contractual right**:

 (i) to receive cash or another financial asset from another entity; or

 (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity; or

(d) a contract that will or may be settled in **entity's own equity instruments** and is:

 (i) a non-derivative for which the entity is or may be obliged to receive a variable number of entity's own equity instruments; or

 (ii) a derivative that will or may be settled other than by exchange of fixed amount of cash or another financial asset for a fixed number of entity's own equity instruments. For this purpose, entity's own equity instruments do not include puttable financial instruments classified as equity instruments, instruments that impose on the entity an obligation to deliver to another party a pro-rata share of net assets of the entity on liquidation and are classified as equity instruments, or instruments that are themselves contracts for future receipt or delivery of entity's own equity instruments.

- On the basis of the above definition, some of the key elements to understand:

Cash	❖ Currency (cash) is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and recognised in financial statements. ❖ A deposit of cash with bank or other financial institution represents a contractual right of the depositor to obtain cash from the institution or to draw a cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability.
Contractual right to receive cash or other financial asset	❖ A contractual right or contractual obligation to receive, deliver or exchange financial instruments is itself a financial instrument. A chain of contractual rights or contractual obligations meets the definition of a financial instrument if it will ultimately lead to the receipt or payment of cash or to the acquisition or issue of an equity instrument. Common examples of contractual right to receive cash and corresponding financial liability representing other party's contractual obligation to deliver cash in future are: 1. Trade accounts receivable; 2. Loans and Notes receivable 3. Deposits made; 4. Investment in bonds, etc. ❖ The ability to exercise a contractual right or to satisfy a contractual obligation may be absolute or it may be contingent on occurrence of one or more future events, not wholly within the control of either party to the contractual arrangement. A contingent right and obligation meets the definition of financial asset and financial liability, even though such assets and liabilities are not always recognized in the financial statements. For eg.: A lender may be provided with a financial guarantee by a party ('guarantor') on behalf of borrower, entitling to recover the outstanding dues from the guarantor if the borrower were to default, etc.

- **Physical assets, *right-of-use assets* and intangible assets**

  Physical assets (such as inventories, property, plant and equipment), ***right-of-use assets*** and intangible assets (such as patents and trademarks) are not financial assets. Control of such physical assets, ***right-of-use assets*** and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset.

- **Prepaid expenses**

  - Assets (such as prepaid expenses) for which the future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets.
  - Similarly, items such as deferred revenue and most warranty obligations are not financial liabilities because the outflow of economic benefits associated with them is the delivery of goods and services rather than a contractual obligation to pay cash or another financial asset.

- **'Perpetual' debt instruments**

  Perpetual debt instruments such as 'perpetual' bonds, debentures and capital notes) normally provide the holder with the contractual right to receive payments on account of interest at fixed dates extending into indefinite future, either with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the future.

Illustration 1: Trade receivables

A Ltd. makes sale of goods to customers on credit of 45 days. The customers are entitled to earn a cash discount @ 2% per annum if payment is made before 45 days and an interest @ 10% per annum is charged for any payments made after 45 days. Company does not have a policy of selling its debtors and holds them to collect contractual cash flows. Evaluate the financial instrument.

Solution

In the above case, the trade receivable recorded in books represents contractual cash flows that are solely payments of principal (and interest if paid beyond credit period). Further, Company' s business model is to collect contractual cash flows.

Hence, this meets the definition of financial assets carried at amortised cost.

*****

Illustration 2: Deposits

Z Ltd. (the 'Company') makes sale of goods to customers on credit. Goods are carried in large containers for delivery to the dealers' destinations. All dealers are required to deposit a fixed amount of ₹ 10,000 as security for the containers, which is returned only when the contract with

Company terminates. The deposits carry 8% per annum which is payable only when the contract terminates. If the containers are returned by the dealers in broken condition or any damage caused, then appropriate adjustments shall be made from the deposits at the time of settlement. How would such deposits be treated in books of the dealers?

Solution

In this case, deposits are receivable in cash at the end of contract period between the dealer and the Company. These deposits represent cash flows that are solely payments of principal and interest. Moreover, these deposits normally cannot be sold. Hence, they meet the definition of financial asset carried at amortised cost.

*****

Illustration 3: Perpetual debt instruments

A Ltd. issues a bond at principal amount of CU 1000 per bond. The terms of bond require annual payments in perpetuity at a stated interest rate of 8 per cent applied to the principal amount of CU 1000. Assuming 8 per cent to be the market rate of interest for the instrument when it was issued, the issuer assumes a contractual obligation to make a stream of future interest payments having a fair value (present value) of CU1,000 on initial recognition. Evaluate the financial instrument in the hands of both the holder and the issuer.

Solution

- For the Holder – right to receive cash in future – classifies to be a financial asset
- For the Issuer – contractual obligation to pay cash in future – classifies to be a financial liability.

*****

1.4 WHAT IS A FINANCIAL LIABILITY?

- A **financial liability** is any liability that is:

  (a) A **contractual obligation**:

    (i) To deliver cash or other financial asset to another entity; or

    (ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity;

  or

  (b) A contract that will or may be settled in entity's **own equity instruments** and is:

    (i) A **non-derivative** for which the entity is or may be obliged to deliver a **variable** number of entity's own equity instruments; or

(ii) a **derivative** that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

As an exception, following type of instruments that meets the definition of a financial liability may still be classified as an equity instrument if they have certain features and meets specific conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of Ind AS 32.

For details, refer Unit 2 – Equity and Financial Liabilities.

Illustration 4: Creditors for sale of goods

A Ltd. (the 'Company') makes purchase of steel for its consumption in normal course of business. The purchase terms provide for payment of goods at 30 days credit and interest payable @ 12% per annum for any delays beyond the credit period. Analyse the nature of this financial instrument.

Solution

A Ltd. has entered into a contractual arrangement for purchase of goods at a fixed consideration payable to the creditor. A contractual arrangement that provides for payment in fixed amount of cash to another entity meets the definition of financial liability.

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Illustration 5: Contract for exchange on unfavorable conditions

A Ltd. (the 'Company') makes a borrowing for INR 10 lacs from RBC Bank, with bullet repayment of INR 10 lacs and an annual interest rate of 12% per annum. Now, Company defaults at the end of 5th year and consequently, a rescheduling of the payment schedule is made beginning 6th year onwards. The Company is required to pay INR 1,300,000 at the end of 6th year for one time settlement, in lieu of defaults in payments made earlier.

(a) Does the above instrument meet definition of financial liability? Please explain.

(b) Analyse the differential amount to be exchanged for one-time settlement.

Solution

(a) A Ltd. has entered into an arrangement wherein against the borrowing, A Ltd. has contractual obligation to make stream of payments (including interest and principal). This meets definition of financial liability.

(b) Let's compute the amount required to be settled and any differential arising upon one time settlement at the end of 6th year –

- Loan principal amount = ₹ 10,00,000
- Amount payable at the end of 6th year = ₹ 12,54,400 [10,00,000 * 1.12 * 1.12 (Interest for 5th& 6th year in default plus principal amount)]
- One time settlement = INR 13,00,000
- Additional amount payable = ₹ 45,600

The above represents a contractual obligation to pay cash against settlement of a financial liability under conditions that are unfavorable to A Ltd. (owing to additional amount payable in comparison to amount that would have been paid without one time settlement). Hence, the rescheduled arrangement meets definition of 'financial liability'.

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Illustration 6 : Derivative contract:

Entity – B Ltd writes an option contract for sale of shares of Target Ltd. at a fixed price of ₹ 100 per share to C Ltd. This option is exercisable anytime for a period of 90 days ('American option'). Evaluate this under definition of financial instrument.

Solution

In the above case – B Ltd has written an option, which if exercised by C Ltd. will result in B Ltd. selling equity shares of Target Ltd. for fixed cash of ₹ 100 per share. Such option will be exercised by C Ltd. only if the market price of shares of Target Ltd. increases beyond ₹ 100, thereby resulting in contractual obligation over B Ltd. to settle the contract under potential unfavorable terms.

In the above case, if the market price is already ₹ 120 which means that if option is exercised by C Ltd, then B Ltd shall buy shares from the market at ₹ 120 per share and sell at ₹ 100, thereby resulting in a loss or exchange at unfavorable terms to B Ltd. Hence, it meets the definition of financial liability in books of B Ltd.

The additional question that arises here is the nature of this financial liability and if it meets the definition of derivative. A derivative is a financial instrument that meets following conditions –

(a) Its value changes in response to change in specified variable like interest rate, equity index, commodity price, etc. If the variable is non-financial, it is not specific to party to the contract

(b) It requires no or little initial net investment

(c) It is settled at a future date.

Evaluating the above instrument, B Ltd. has written an option whose value changes based on change in market price of equity share, it requires no initial net investment and is settled at a future date (anytime in 90 days). Hence, it meets definition of derivative financial liability in books of B Ltd.

*****

For detailed analysis on derivatives, refer Unit 5 : Derivatives and Embedded Derivatives.

Illustration 7: Settlement in variable number of shares

Target Ltd. took a borrowing from Z Ltd. for ₹ 10,00,000. Z Ltd. enters into an arrangement with Target Ltd. for settlement of the loan against issue of a certain number of equity shares of Target Ltd. whose value equals ₹ 10,00,000. For this purpose, fair value per share (to determine total number of equity shares to be issued) shall be determined based on the market price of the shares of Target Ltd. at a future date, upon settlement of the contract. Evaluate this under definition of financial instrument.

Solution

In the above scenario, Target Ltd. is under an obligation to issue variable number of equity shares equal to a total consideration of ₹ 10,00,000. Hence, equity shares are used as currency for purpose of settlement of an amount payable by Target Ltd. Since this is variable number of shares to be issued in a non-derivative contract for fixed amount of cash, it tantamounts to use of equity shares as 'currency' and hence, this contract meets definition of financial liability in books of Target Ltd.

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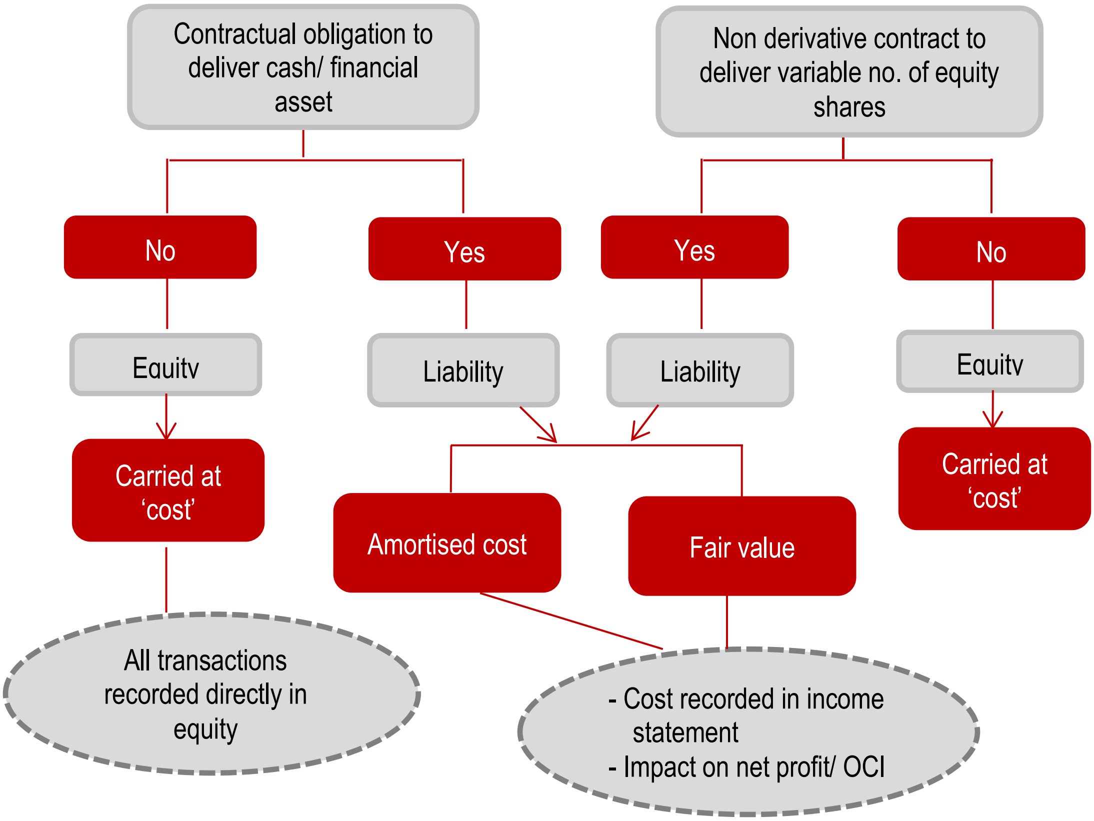
This can be better understood better when we understand the definition of Equity Instrument.

1.5 WHAT IS AN EQUITY INSTRUMENT?

- As per Ind AS 32.11 – An **equity instrument** is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.
- As per Ind AS 32.16 – An instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met:
  - (a) The instrument includes **no contractual obligation**:
    - (i) to deliver cash or another financial asset to another entity; or
    - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.
  - (b) If the instrument will or may be settled in the **issuer's own equity instruments**, it is:
    - (i) a **non-derivative** that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
    - (ii) a **derivative** that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the issuer's own equity instruments do not include instruments that have all the features and meet the conditions described in paragraphs 16A and 16B or paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the issuer's own equity instruments.

      A contractual obligation, including one arising from a derivative financial instrument, that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument.
- Basis the above definition, there is a thin line of difference between equity and financial liability, which can be understood with the help of following diagrammatic presentation –



- The **key characteristics** of an equity instrument have been further explained as follows:

No contractual obligation	❖ A key characteristic of equity instruments is that they carry no contractual obligation throughout for any payment or distribution towards the holders of such instruments. ❖ However, following type of instruments as an exception are 'equity' classified even if they contain an obligation to deliver cash or other financial asset, provided certain requisite criteria are met – 1. puttable financial instruments that meet certain conditions 2. an instrument, or a component of an instrument, that contains an obligation for the issuing entity to deliver to the holder a pro rata share of the net assets of the issuing entity only on its liquidation. The nature of these instruments and the criteria to be met for equity classification are explained in greater detail in Unit 2 – Equity and Financial Liabilities.

Settlement in own equity instruments	❖ Settlement in own equity instruments is equity classified only if it's a fixed-for-fixed transaction, ie, issue of fixed number of shares and involves a fixed amount of cash or other financial asset. ❖ Where an entity enters into a non-derivative contract to issue a fixed number of its own equity instruments in exchange for a fixed amount of cash (or another financial asset), it is an equity instrument of the entity. But this does not apply for instruments that are equity classified being a puttable instrument or other instrument entitling the holder to pro-rata share in net assets that meet specified criteria (refer Unit 2 – Equity and Financial Liabilities). ❖ However, if such a contract contains an obligation for the entity to pay cash (or another financial asset), it also gives rise to a liability for the present value of the redemption amount. For example: a forward contract entered into by an entity to repurchase fixed number of its own shares for a fixed amount of cash gives rise to a financial liability to be recorded at present value of redemption amount.

- An issuer of non-puttable ordinary shares assumes a liability when it formally acts to make a distribution and becomes legally obliged to the shareholders to do so. This may be the case following the declaration of a dividend or when the entity is being wound up and any assets remaining after the satisfaction of liabilities become distributable to shareholders.

Example

When a Company proposes dividend in its board meeting, no obligation arises because it becomes payable only post approval by shareholders in the annual general meeting. However, when the dividend is approved by shareholders in annual general meeting, the Company has taken an obligation to distribute dividend to its shareholders and hence, it's a contractual obligation meeting the definition of financial liability.

- **Examples** of equity instruments include:
    - ♦ Non-puttable ordinary shares, for eg.: or equity shares issued by companies
    - ♦ Some puttable instruments (if they meet requisite criteria and are not classified as financial liabilities);
    - ♦ Some instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation (if they meet requisite criteria and are not classified as financial liabilities);
    - ♦ Some types of preference shares (where repayment and distribution is at the discretion of the Issuer);

- Warrants or written call options that allow the holder to subscribe for or purchase a fixed number of non-puttable ordinary shares in the issuing entity in exchange for a fixed amount of cash or another financial asset.

- Basis the above definition of equity and characteristics of such instruments, let's evaluate some typical form of instruments that may be issued and how are they classified –

  - **Preference shares**

    Preference shares is a class of shares issued by Indian companies, whose terms may provide for redemption at a pre-determined amount or may be irredeemable, with a fixed return which may be cumulative or discretionary. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attached to the share to determine whether it exhibits the fundamental characteristic of a financial liability or an equity instrument, as explained below:

(A) Redeemable preference shares:

Redemption terms	Evaluation under Ind AS 32
Redemption at a specified date Redemption at option of Holder	This contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation. **Hence, classified as 'financial liability'.**
Redemption at option of Issuer	An option of the issuer to redeem shares for cash does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders. **Hence, classified as 'equity instrument'**. An obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares, at which time this instrument shall be reclassified from 'equity' to 'financial liability'.

(B) Non-redeemable preference shares

In this case, appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument.

- When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments.
- The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:
  - (a) a history of making distributions;
  - (b) an intention to make distributions in the future
  - (c) a possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends on the ordinary shares if dividends are not paid on the preference shares)
  - (d) the amount of the issuer's reserves
  - (e) an issuer's expectation of a profit or loss for a period; or
  - (f) an ability or inability of the issuer to influence the amount of its profit or loss for the period.

Hence, the contractual terms determine the nature of instrument. Any historical trend or ability of the Issuer does not affect the classification of an instrument as 'equity' or 'financial liability'.

(C) Distributions on preference shares

Other than the terms for redemption of financial instrument, another important point for consideration is whether the Company has an obligation to make payments of dividend ie, whether dividend on such preference shares are cumulative or non-cumulative.

- **Where dividends are at the discretion of the issuer –**this is akin to an equity instrument. However, where the instrument itself is redeemable, the obligation to pay still exists but only to the extent of the redemption value and not dividends on such shares unless they are declared.
- **Where dividends are cumulative but payable only on liquidation**–One needs to assess the key terms of the instrument to check if the entity has a contractual obligation:
  - **(a)** **Where no contractual obligation exists to pay**– such preference shares may themselves be irredeemable and the dividend on such shares even if cumulative, the entity may be under no obligation to pay unless upon liquidation – then such preference shares may be classified as equity.

(b) **Where contractual obligation exists –** In cases where the preference shares are not redeemable, it is like an equity instrument. But if they are entitled to dividend which is payable such that entity does not have an unconditional right to defer payment, then this provides the shareholders with a lender's return on the amount invested. This obligation is also not negated if the entity is unable to pay such dividend for lack of funds or insufficient distributable profits. Therefore, the obligation to pay dividend meets the definition of financial liability. The instrument in such cases shall have two components – financial liability represented by dividend and equity component represented by the issue price, such instruments are overall classified as 'compound financial instruments' and each of the components as mentioned above are accounted separately.

- **Contracts settled in own equity instruments but classified as 'financial liability' (where equity instrument is treated as currency) –**

Terms	Evaluation under Ind AS 32
Non derivative contract	o A contract that will be settled in a variable number of entity's own shares whose value equals a fixed amount is a financial liability, because the entity is under an obligation to pay a fixed amount, that is settled through equity instruments (similar to settlement in currency). o Similarly, a contract that will be settled in a fixed number of the entity's own shares, but the rights attaching to those shares will be varied so that the settlement value equals a fixed amount or an amount based on changes in an underlying variable, is a financial asset or a financial liability.
Derivative contract	A contract that will be settled in a variable number of the entity's own shares whose value equals an amount based on changes in an underlying variable (eg a commodity price) is a financial asset or a financial liability. An example is a written option to buy gold that, if exercised, is settled net in the entity's own instruments by the entity delivering as many of those instruments as are equal to the value of the option contract.

Illustration 8: Preference shares with non-cumulative dividend

Silver Ltd. issued irredeemable preference shares with face value of ₹ 10 each and premium of ₹ 90. These shares carry dividend @ 8% per annum, however dividend is paid only when Silver Ltd declares dividend on equity shares. Analyse the nature of this instrument.

Solution

In the above case, two main characteristics of the preference shares are:

(i) Preference shares carry dividend, which is payable only when Company declares dividend on equity shares

(ii) Preference share are irredeemable.

Analysing the definition of equity, an instrument meets definition of equity if:

(a) It contains no contractual obligation to pay cash; and

(b) Where an instrument shall be settled in own equity instruments, it's a non-derivative contract that will be settled only by issue of fixed number of shares or a derivative contract that will be settled by issue of fixed number of shares for a fixed amount of cash.

In the above instrument, there is no contractual obligation on the Company to pay cash since –

(i) Face value is not redeemable (except in case of liquidation); and

(ii) Dividend is payable only if Company declares dividend on equity shares. Since dividend on equity shares is discretionary and the Company can choose not to pay, Company has an unconditional right to avoid payment of cash on preference shares also.

Hence, preference shares meet definition of equity instrument.

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Illustration 9: Non-derivative contract to be settled in own equity instruments

A Ltd. invests in compulsorily convertible preference shares (CCPS) issued by its subsidiary – B Ltd. at ₹ 1,000 each (₹ 10 face value + ₹ 990 premium). Under the terms of the instrument, each CCPS is compulsorily convertible into one equity share of B Ltd at the end of 5 years. Such CCPS carry dividend @ 12% per annum, payable only when declared at the discretion of B Ltd. Evaluate this under definition of financial instrument.

Solution

B Ltd. has issued CCPS which provide for –

(a) Conversion into fixed number of equity shares, ie, one equity share for every CCPS

(b) Non-cumulative dividends.

Applying the definition of 'equity' under Ind AS 32 –

(a) There is no contractual obligation to deliver cash or other financial asset. Dividends are payable only when declared and hence, at the discretion of the Issuer – B Ltd., thereby resulting in no contractual obligation over B Ltd.

(b) Conversion is into a fixed number of equity shares.

Hence, it meets definition of equity instrument and shall be classified as such in books of B Ltd.

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Illustration 10: Derivative contract to be settled in own equity instruments

A Ltd. issues warrants to all existing shareholders entitling them to purchase additional equity shares of A Ltd. (with face value of ₹ 100 per share) at an issue price of ₹ 150 per share. Evaluate whether this constitutes an equity instrument or a financial liability?

Solution

In this case, Company A Ltd. has issued warrants entitling the shareholders to purchase equity shares of the Company at a fixed price. Hence, it constitutes a contractual arrangement for issuance of fixed number of shares against fixed amount of cash.

Now, evaluating this contract under definition of derivative –

(i) The value of warrant changes in response to change in value of underlying equity shares;

(ii) This involves no initial net investment

(iii) It shall be settled at a future date.

Hence, this warrant meets the definition of derivative.

Applying definition of equity under Ind AS 32, a derivative contract that will be settled by exchange of fixed number of equity shares for fixed amount of cash meets definition of equity instrument. The above contract is derivative contract that will be settled by issue of fixed number of own equity instruments by A Ltd. for fixed amount of cash and hence, meets definition of equity instrument.

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1.6 SCOPE OF FINANCIAL INSTRUMENTS

Scope of financial instruments excludes the following:

(a) Interests in subsidiaries, associates and joint ventures that are accounted for in accordance with Ind AS 110 *Consolidated Financial Statements*, Ind AS 27 *Separate Financial Statements* or Ind AS 28 *Investments in Associates and Joint Ventures*. However, in some cases, Ind AS 110, Ind AS 27 or Ind AS 28 require or permit an entity to account for an interest in a subsidiary, associate or joint venture in accordance with some or all of the requirements of this Standard. Entities shall also apply this Standard to derivatives on an interest in a subsidiary, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in Ind AS 32 *Financial Instruments: Presentation*.

(b) Rights and obligations under leases to which ***Ind AS 116 Leases applies. However,***

(i) finance lease receivables (i.e. net investments in finance leases) and operating lease receivables recognised by a lessor are subject to the derecognition and impairment requirements of this Standard;

(ii) lease liabilities recognised by a lessee are subject to the derecognition requirements in paragraph 3.3.1 of this Standard; and

(iii) derivatives that are embedded in leases are subject to the embedded derivatives requirements of this Standard.

(c) employers' rights and obligations under employee benefit plans, to which Ind AS 19 *Employee Benefits* applies.

(d) rights and obligations arising under (i) an insurance contract as defined in Ind AS 104 *Insurance Contracts*, other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract, or (ii) a contract that is within the scope of Ind AS 104 because it contains a discretionary participation feature.

- However, this Standard applies to a derivative that is embedded in a contract within the scope of Ind AS 104 if the derivative is not itself a contract within the scope of Ind AS 104.
- Moreover, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting that is applicable to insurance contracts, the issuer may elect to apply either this Standard or Ind AS 104 to such financial guarantee contracts. The issuer may make that election contract by contract, but the election for each contract is irrevocable.

(e) Any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination within the scope of Ind AS 103 *Business Combinations* at a future acquisition date. The term of the forward contract should not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction.

(f) Loan commitments other than those loan commitments described below –

- loan commitments that the entity designates as financial liabilities at fair value through profit or loss. An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination shall apply this Standard to all its loan commitments in the same class.
- loan commitments that can be settled net in cash or by delivering or issuing another financial instrument. These loan commitments are derivatives. A loan commitment is not regarded as settled net merely because the loan is paid out in instalments (for example, a mortgage construction loan that is paid out in instalments in line with the progress of construction).
- commitments to provide a loan at a below-market interest rate

However, an issuer of loan commitments shall apply the impairment requirements of this Standard to loan commitments that are not otherwise within the scope of this Standard. Also, all loan commitments are subject to the derecognition requirements of this Standard.

(g) Financial instruments, contracts and obligations under share-based payment transactions to which Ind AS 102 *Share-based Payment* applies, except for contracts to buy non-financial items as described below.

(h) Rights to payments to reimburse the entity for expenditure that it is required to make to settle a liability that it recognises as a provision in accordance with Ind AS 37 *Provisions, Contingent Liabilities and Contingent Assets*, or for which, in an earlier period, it recognised a provision in accordance with Ind AS 37.

(i) Rights and obligations within the scope of Ind AS 115 *Revenue from Contracts with Customers* that are financial instruments, except for those that Ind AS 115 specifies are accounted for in accordance with this Standard.

1.7 CONTRACTS TO BUY OR SELL NON-FINANCIAL ITEMS ('OWN USE EXEMPTION')

- Contracts to buy or sell non-financial items are outside the scope of 'financial instruments', except for the following:

  (a) Contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

  (b) A contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments that are irrevocably designated as measured at fair value through profit or loss (even if it was entered into for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements). This designation is available only at inception of the contract and only if it eliminates or significantly reduces a recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from not recognising that contract because it is excluded from the scope of this Standard applying the scope exclusion in (a) above.

  (c) A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, where such a contract was not entered into for the purpose of receipt or delivery of the non-financial item in accordance with entity's expected purchase, sale or usage requirements.

- There are various ways in which a contract to buy or sell non-financial items can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:

  (a) when the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;

  (b) when the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);

(c) when, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and

(d) when the non-financial item that is the subject of the contract is readily convertible to cash.

Example

ABC Ltd. enters into a contract to buy 100 tonnes of cocoa beans at 1,000 per tonne for delivery in 12 months. On the settlement date, the market price for cocoa beans is 1,500 per tonne. If the contract cannot be settled net in cash and this contract is entered for delivery of cocoa beans in line with ABC Ltd.'s expected purchase/ usage requirements, then own-use exemption applies. In such case, the contract is considered to be an executory contract outside the scope of Ind AS 109 and hence, shall not be accounted as a derivative.

1.8 CARVE OUT IN IND AS 32 FROM IAS 32

As per IFRS

As per accounting treatment prescribed under IAS 32, equity conversion option in case of foreign currency denominated convertible bonds is considered a derivative liability which is embedded in the bond. Gains or losses arising on account of change in fair value of the derivative need to be recognised in the statement of profit and loss as per IAS 32.

Carve out

In Ind AS 32, an exception has been included to the definition of 'financial liability' in paragraph 11 (b) (ii), whereby conversion option in a convertible bond denominated in foreign currency to acquire a fixed number of entity's own equity instruments is classified as an equity instrument if the exercise price is fixed in any currency.

Reasons

This treatment as per IAS 32 is not appropriate in instruments, such as, FCCBs since the number of shares convertible on the exercise of the option remains fixed and the amount at which the option is to be exercised in terms of foreign currency is also fixed; merely the difference in the currency should not affect the nature of derivative, i.e., the option. Further, the fair value of the option is based on the fair value of the share prices of the company. If there is decrease in the share price, the fair value of derivative liability would also decrease which would result in recognition of gain in the statement of profit and loss. This would bring unintended volatility in the statement of profit and loss due to volatility in share prices. This will also not give a true and fair view of the liability as in this situation, when the share prices fall, the option will not be exercised. However, it has been considered that if such option is classified as equity, fair value changes would not be required to be recognised. Accordingly, the exception has been made in definition of financial liability in Ind AS 32.

UNIT 2: FINANCIAL INSTRUMENTS: EQUITY AND FINANCIAL LIABILITIES

2.1 INTRODUCTION

Ind AS 32 lays down the accounting principles for classifying a financial instrument issued by an entity as either a financial liability or equity or both (a compound instrument). The classification of a financial instrument is governed by the substance of a contract and not its legal form.

As you would see in the following paragraphs, classification of a financial instrument into financial liability or equity or compound involves analysis of each component of a contract. Incorrect classification results in misstatement of financial statements and significantly affects the financial ratios that are derived therefrom.

2.2 DEFINITIONS – FINANCIAL LIABILITY AND EQUITY

It is important to read paragraphs 11 and 16 of Ind AS 32 together to identify the accounting principles that distinguish a financial liability instrument from an equity instrument.

Before we look at the two definitions in a comparative format, it is important to highlight here that the classification of a financial instrument under Ind AS 32 is done from the perspective of the issuer and not from the perspective of the holder.

Financial liability (Ind AS 32.11)	Equity (Ind AS 32.16)
A financial instrument that fulfils **either of (A) or (B)** below: Condition (A): An instrument that **is a contractual obligation**: i. to deliver cash or another financial asset to another entity; or ii. to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity	A financial instrument that fulfils **both (A) and (B)** below: Condition (A): An instrument that contains **no contractual obligation**: i. to deliver cash or another financial asset to another entity; or ii. to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity

Condition (B): An instrument that will or may be settled in the entity's own equity instruments and is: i. a non-derivative **for which the entity is or may be obliged** to deliver a variable number of the entity's own equity instruments; or ii. a derivative that will or may be settled **other than by** the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.	Condition (B): An instrument that will or may be settled in the entity's own equity instruments and is: i. a non-derivative **that includes no contractual obligation for the issuer** to deliver a variable number of the entity's own equity instruments; or ii. a derivative that will or may be settled **only by** the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

As can be seen from the table above, the two definitions are mirror images of each other. In the following paragraphs, we will discuss each of these aspects in detail.

Importance of the phrase "contract" and "contractual"

It is important to know that 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing [Ind AS 32.13]. Liabilities that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities. Accounting for income taxes is dealt with in Ind AS 12. Similarly, constructive obligations, as defined in Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets, do not arise from contracts and are not financial liabilities.

Items such as deferred revenue and most warranty obligations are not financial liabilities because the outflow of economic benefits associated with them is the delivery of goods and services rather than a contractual obligation to pay cash or another financial asset. [Ind AS 32.AG11]

It should also be remembered that the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. For example, a financial guarantee is a contractual obligation of the guarantor to pay the lender, if the borrower defaults [Ind AS 32.AG8].

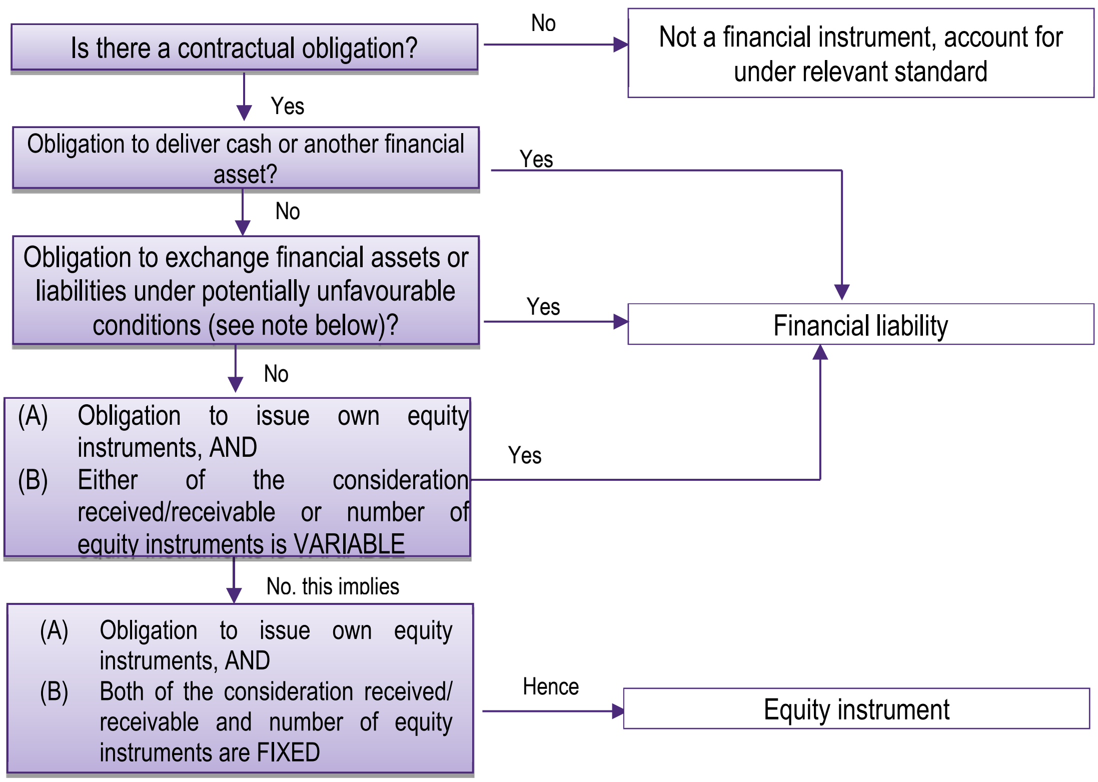
Analysis of the definitions

The following points must be remembered in determination of classification of a financial instrument as a financial liability or equity:

- ***Evaluation of components***- it is not always that the entire instrument is either a financial liability or equity. The issuer makes this determination for each component part of a contract in accordance with 'substance' thereof and definitions given above [Ind AS 32.15].

- ***Contract is supreme* -** The evaluation of 'substance' does not override or contravene the contractual terms.
- ***Contract cannot override laws* -** The entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or equity. Those terms and conditions include relevant local laws, regulations and the entity's governing charter in effect at the date of classification, but not expected future amendments to those laws, regulations or charter.

The flowchart below summarises the distinction between the definitions of a financial liability and equity:



Note: Potential unfavourable conditions

Example:

PQR Ltd. issues a call option (i.e. an option to buy) to ABC Ltd. to subscribe to PQR Ltd.'s equity shares at a price of ₹ 100 per share. The call option is to be settled on a 'net' basis i.e. without physical delivery of shares. If at the balance sheet date, market value of equity share of PQR Ltd. is ₹ 110 per share, PQR Ltd. will be obliged to pay ₹ 10 to settle the option. Such a condition is potentially unfavourable to PQR Ltd. and hence ₹ 10 represents a financial liability for PQR Ltd.

2.3 OBLIGATION TO DELIVER CASH

A critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of the issuer either to deliver cash or another financial asset to the holder or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer (Ind AS 32.17).

There are very limited exceptions to this principle in the form of "puttable instruments" and "obligations arising on liquidation". We will discuss these exceptions in the subsequent paragraphs, "Puttable instruments and obligations arising on liquidation".

The financial instrument is a financial liability even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease. [Ind AS 32.18(b)]

Subject to certain exceptions as mentioned above, if an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability. (Ind AS 32.19)

A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions. (Ind AS 32.20)

Illustration 1: Redeemable preference shares with mandatory dividend (refer Example 1 in section "Learning objective")

A Ltd. (issuer) issues preference shares to B Ltd. (holder). Those preference shares are redeemable at the end of 10 years from the date of issue and entitle the holder to a cumulative dividend of 15% p.a. The rate of dividend is commensurate with the credit risk profile of the issuer. Examine the nature of the financial instrument.

Solution

This instrument provides for mandatory fixed dividend payments and redemption by the issuer for a fixed amount at a fixed future date. Since there is a contractual obligation to deliver cash (for both dividends and repayment of principal) to the preference shareholder that cannot be avoided, the instrument is a financial liability in its entirety.

*****

Illustration 2: Redeemable debentures with discretionary dividend

X Co. Ltd. (issuer) issues debentures to Y Co. Ltd. (holder). Those debentures are redeemable at the end of 10 years from the date of issue. Interest of 15% p.a. is payable at the discretion of the issuer. The rate of interest is commensurate with the credit risk profile of the issuer. Examine the nature of the financial instrument.

Solution

This instrument has two components – (1) mandatory redemption by the issuer for a fixed amount at a fixed future date, and (2) interest payable at the discretion of the issuer.

The first component is a contractual obligation to deliver cash (for repayment of principal with or without premium, as per terms) to the debenture holder that cannot be avoided. This component of the instrument is a financial liability.

*****

Illustration 3: Perpetual loan with mandatory interest

P Co. Ltd. (issuer) takes a loan from Q Co. Ltd. (holder). The loan is perpetual and entitles the holder to fixed interest of 8% p.a. Examine the nature of the financial instrument.

Solution

This instrument has two components – (1) mandatory interest by the issuer for a fixed amount at a fixed future date, and (2) perpetual nature of the principal amount.

The first component is a contractual obligation to deliver cash (for payment of interest) to the lender that cannot be avoided. This component of the instrument is a financial liability.

*****

Illustration 4: Restriction on the ability of an entity to satisfy a contractual obligation

Does the lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, will lead to contractual obligation?

Solution

Lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate the entity's contractual obligation or the holder's contractual right under the instrument.

*****

Illustration 5: Optionally convertible redeemable preference shares

D Ltd. issues preference shares to G Ltd. The holder has an option to convert these preference shares to equity instruments of the issuer anytime up to a period of 10 years. If the option is not exercised by the holder, the preference shares are redeemed at the end of 10 years. Examine the nature of the financial instrument.

Solution

This instrument has two components – (1) contractual obligation that is conditional on holder exercising its right to redeem, and (2) conversion option with the holder.

The first component is a financial liability because the entity does not have the unconditional right to avoid delivering cash.

In the section "Compound financial instruments", we will also analyse the other component – the conversion option with the holder and we will explain the nature of the instrument in its entirety.

*****

Illustration 6: Settlement alternative is non-financial obligation

LMN Ltd. issues preference shares to PQR Ltd. These preference shares are redeemable at the end of 5 years from the date of issue.

The instrument also provides a settlement alternative to the issuer whereby it can transfer a particular commercial building to the holder, whose value is estimated to be significantly higher than the cash settlement amount. Examine the nature of the financial instrument.

Solution

Such preference shares are financial liability because the entity can avoid a transfer of cash or another financial asset only by settling the non-financial obligation.

*****

2.3.1 Puttable instruments and obligations arising on liquidation – Exceptions to classification as 'financial liability' for instruments settled in cash or another financial asset

Let us analyse this in the following two contexts:

A. Mutual funds and unit trusts, wherein the redemption amount is equal to a proportionate share in the net assets of the entity

B. Limited life entities like special purpose vehicles (SPV) for execution of an infrastructure project

First, let us look at one definition which is relevant for our discussion – "Puttable instrument" is a financial instrument that gives the holder:

- the right to put the instrument back to the issuer for cash or another financial asset, or
- is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

[The phrase "put back to the issuer" refers to redemption of the instrument. If the holder has a right, but not an obligation to require the issuer to redeem the instrument, it is referred to as "put option".]

As discussed above, financial instruments that contain an obligation of the issuer to deliver cash or another financial asset are classified as financial liabilities. As per this principle, the following shall be classified as financial liabilities:

- Puttable instruments (see context A above), and
- Instruments that create an obligation only on liquidation of the entity (see context B above). Liquidation may be certain to occur and outside issuer's control or uncertain to occur and at the option of holder.

However, Ind AS 32 contains an exception whereby such instruments are classified as "equity", despite the fact that they otherwise meet all the conditions for "financial liability". This exception applies if **all** of the following conditions are fulfilled by the instrument (Ind AS 32.16A, 16B, 16C and 16D):

1. It **entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation**. In other words, the instrument should not entitle its holder to a higher or lower share of entity's net assets upon liquidation.

   The logic behind this requirement is that entitlement to a pro rata share of the entity's net assets on liquidation is equivalent to having a residual interest in the assets of an entity.

   Illustration 7: Cap on amount payable on liquidation

   ABC Ltd. has two classes of puttable shares – Class A shares and Class B shares. On liquidation, Class B shareholders are entitled to a pro rata share of the entity's residual assets up to a maximum of ₹ 10,000,000.

   There is no limit to the rights of the Class A shareholders to share in the residual assets on liquidation. Examine the nature of the financial instrument.

   Solution

   The cap of ₹ 10,000,000 means that Class B shares do not have entitlement to a pro rata share of the residual assets of the entity on liquidation. They cannot therefore be classified as equity.

*****

2. It is in the class of instruments that is **subordinate to all other classes of instruments**, that is, in its present form, it has no priority over other claims to the entity's assets **on liquidation** (entity will need to assume liquidation on date of classification).

   Illustration 8: Investment manager's share in a mutual fund

   Mutual Fund X has an Investment Manager Y. At the inception of the fund, Y had invested a nominal or token amount in units of X. Such units rank last for repayment in the event of liquidation. Accordingly, they constitute the most subordinate class of instruments. Examine the nature of the financial instrument.

Solution

Resultantly, the units held by other unit holders are classified as financial liability as they are not the most subordinate class of instruments – they are entitled to pro rate share of net assets on liquidation, and their claim has a priority over claims of Y.

It may be noted that the most subordinate class of instruments may consist of two or more legally separate types of instruments.

*****

3. (a) In case of puttable instruments, all financial instruments in the most subordinate class have **identical features**: For example, they must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class.

Illustration 9: Differential voting rights

T Motors Ltd. has issued puttable ordinary shares and puttable 'A' ordinary shares whereby holders of ordinary shares are entitled to one vote per share whereas holders of 'A' ordinary shares are not entitled to any voting rights. The holders of two classes of shares are equally entitled to receive share in net assets upon liquidation. Examine whether the financial instrument will be classified as equity.

Solution

Neither of the two classes of puttable shares can be classified as equity, as they do not have identical features due to the difference in voting rights. It is not possible for T Motors Ltd. to achieve equity classification of the ordinary shares by designating them as being more subordinate than the 'A' ordinary shares, as this does not reflect the fact that the two classes of share are equally entitled to share in entity's residual assets on liquidation.

*****

(b) In contrast to the above, in case of instruments that impose on the entity an obligation to deliver pro rata share of net assets only on liquidation, all financial instruments in the most subordinate class have such identical contractual obligation.

4. In case of puttable instruments, apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, there are **no other contractual obligations**:

- to deliver cash or another financial asset, or
- to settle in variable number of entity's own equity instruments

In other words, there are no other features of the instrument which could satisfy the definition of "financial liability".

Illustration 10: Conversion into a variable number of equity instruments

S Ltd. has issued a class of puttable ordinary shares to T Ltd. Besides the put option (which is consistent with other classes of ordinary shares), T Ltd. is also entitled to convert the class of ordinary shares held by it into equity instruments of S Ltd. whose number will vary as per the market value of S Ltd. Examine whether the financial instrument will be classified as equity.

Solution

The shares cannot qualify for equity classification in their entirety as in addition to the put option there is also a contractual obligation to settle the instrument in variable number of entity's own equity instruments.

*****

5. In case of puttable instruments, the **total expected cash flows attributable to the instrument** over the life of the instrument are based substantially on the:

   - profit or loss,
   - change in the recognised net assets or
   - change in the fair value of the recognised and unrecognised net assets

   of the entity over the life of the instrument (excluding any effects of the instrument).

   In other words, if the cash flows are attributable to any factors other than the three listed above, for example, an index, the puttable instrument will fail the equity classification.

6. The issuer must have **no other financial instrument or contract** that has:

   - total cash flows on same terms as (5) above, with
   - the effect of substantially restricting or fixing the residual return to the puttable instrument holders.

   The intent behind this "anti-abuse" clause is to ensure that puttable instruments are not artificially structured to satisfy conditions (1) to (5) above and at the same time the holder of that puttable instrument also holds another financial instrument or has entered into another contract with the issuer whose cash flows indirectly restrict or fix the return on puttable instrument.

   However, "another financial instrument" held by or "another contract" entered into, by the holder of puttable instrument, in its capacity as non-owner of puttable instrument, does not affect the classification of the puttable instrument.

Illustration 11: Management fee contract between issuer and puttable instrument holder

P Ltd. has issued puttable ordinary shares to Q Ltd. Q Ltd. has also entered into an asset management contract with P Ltd. whereby Q Ltd. is entitled to 50% of the profit of P Ltd. Normal commercial terms for similar contracts will entitle the service provider to only 4%-6% of the net profits. Examine whether the financial instrument will be classified as equity.

Solution

The puttable ordinary shares cannot qualify for equity classification as (a) in addition to the put option, there is another contract between the issuer (P Ltd.) and holder of puttable instrument (Q Ltd.) whose cash flows are based substantially on profit or loss of issuer, (b) whose contractual terms are not similar to a contract between a non-instrument holder and issuer and (c) it has the effect of substantially restricting return on puttable ordinary shares.

*****

If the terms of asset management contract were assessed to be similar to terms of a contract between a non-instrument holder and the issuer, it would not have precluded equity classification for puttable shares, provided other conditions are met.

To summarise, the following conditions are required to be fulfilled in each of the two contexts set out at the beginning of this paragraphs:

- **Puttable instruments** (see context A above) – conditions (1) to (6)
- **Instruments that create an obligation only on liquidation of the entity** (see context B above) – conditions (1) to (3) and condition (6).

2.3.1.1 Reclassification

- **Date of classification** of a financial instrument as an equity instrument in accordance with exceptions mentioned above – from the date when the instrument has all the features and meets the conditions set out above (Ind AS 32.16E).
- **Date of reclassification** of a financial instrument – from the date when the instrument ceases to have all the features or meet all the conditions set out above (Ind AS 32.16E).

  For example, if an entity redeems all its issued non-puttable instruments and any puttable instrument that remain outstanding have all the features and meet all the conditions mentioned above, the entity shall reclassify the puttable instruments as equity instruments from the date when it redeems the non-puttable instruments.
- **Accounting for reclassification** (Ind AS 32.16F):

Reclassification from	Reclassification to	Measurement	Recognition of difference in carrying amount and measurement of reclassified instrument
Financial liability	Equity	Carrying value at date of reclassification	-N.A.-
Equity	Financial liability	Fair value at date of reclassification	In equity

2.3.2 Obligation to purchase own equity instruments

With the exception of the circumstances described above (paragraphs 16A and 16B or paragraphs 16C and 16D of Ind AS 32), a contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount. This is the case even for derivatives over equity instruments that meet the fixed for fixed test and would be equity in the absence of this rule. (Ind AS 32.23)

Illustration 12: Written put option on own equity instruments

On 1 January 20X1, Entity X writes a put option over 1,00,000 of its own equity shares for which it receives a premium of ₹ 5,00,000.

Under the terms of the option, Entity X may be obliged to take delivery of 1,00,000 of its own shares in one year's time and to pay the option exercise price of ₹ 22,000,000. The option can only be settled through physical delivery of the shares (gross physical settlement). Examine the nature of the financial instrument and how it will be accounted.

Solution

This derivative involves Entity X taking delivery of a fixed number of equity shares for a fixed amount of cash. Even though the obligation for Entity X to purchase its own equity shares for ₹ 22,000,000 is conditional on the holder of the option exercising the option, Entity X has an obligation to deliver cash which it cannot avoid.

The accounting for financial instrument in the above illustration is as below (Ind AS 32.23):

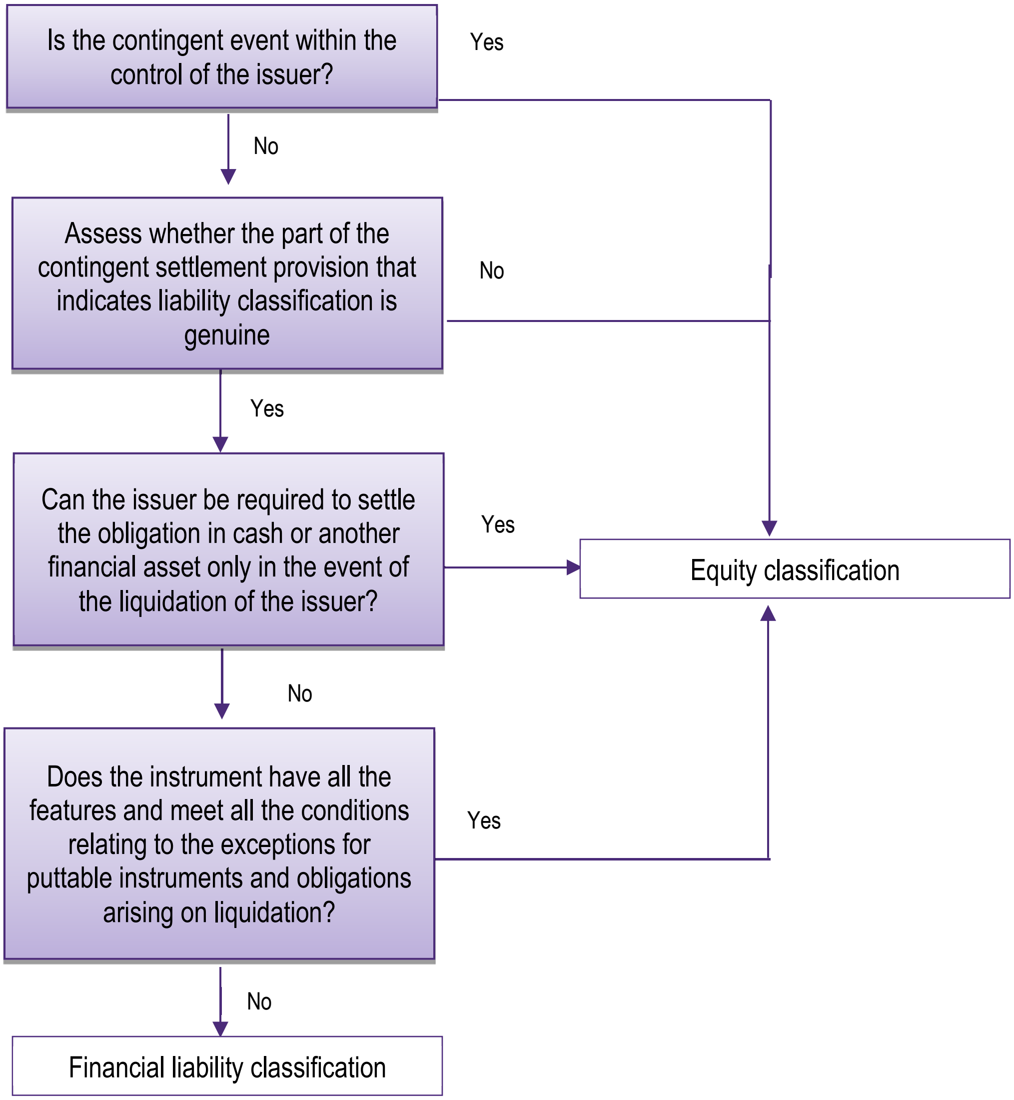
- The financial liability is recognised initially at the present value of the redemption amount, and is reclassified from equity – In the illustration above, this would imply that a financial liability for an amount of present value of ₹ 22,000,000, say ₹ 20,000,000 will be recognised through a debit to equity. The initial premium received (₹ 500,000) is credited to equity.
- Subsequently, the financial liability is measured in accordance with Ind AS 109. While a subsequent paragraph will deal with measurement of financial liabilities, the financial liability of ₹ 20,000,000 in the aforementioned illustration will be measured at amortised cost and finance cost of ₹ 2,000,000 will be recognised over the exercise period.
- If the contract expires without delivery, the carrying amount of the financial liability is reclassified to equity. This means, in case of illustration above, an amount of ₹ 22,000,000 will be reclassified from financial liability to equity.

*****

2.3.3 Contingent settlement provisions

A financial instrument may require an entity to deliver cash or another financial asset, or settle it in some other way that would require it to be classified as a financial liability, but only in the event of the occurrence or non-occurrence of some uncertain future event. The 'event' may be within the control of the issuer or of the holder, or beyond the control of both. These types of contractual arrangements are referred to as 'contingent settlement provisions'.

The flowchart below explains the classification process for contingent settlement provisions:



2.3.4 Written put options over non-controlling interests

In consolidated financial statements, an entity presents non-controlling interests—ie the interests of other parties in the equity and income of its subsidiaries – in accordance with Ind AS 1 and Ind AS 110. When classifying a financial instrument (or a component of it) in consolidated financial statements, an entity considers all terms and conditions agreed between members of the group and the holders of the instrument in determining whether the group as a whole has an obligation to deliver cash or another financial asset in respect of the instrument or to settle it in a manner that results in liability classification.

When a subsidiary in a group issues a financial instrument and a parent or other group entity agrees additional terms directly with the holders of the instrument (eg a guarantee), the group may not have discretion over distributions or redemption. Although the subsidiary may appropriately classify the instrument without regard to these additional terms in its individual financial statements, the effect of other agreements between members of the group and the holders of the instrument is considered in order to ensure that consolidated financial statements reflect the contracts and transactions entered into by the group as a whole.

<u>To the extent that there is such an obligation or settlement provision, the instrument (or the component of it that is subject to the obligation) is classified as a financial liability in consolidated financial statements.</u> (Ind AS 32.AG29)

Illustration 13: Written put option over non-controlling interests

Parent P holds a 70% controlling interest in Subsidiary S. The remaining 30% is held by Entity Z. On 1 January 20X1, P writes an option to Z which grants Z the right to sell its shares to Parent P on 31 December 20X2 for ₹ 1,000. Parent P receives a payment of ₹ 100 for the option. The applicable discount rate for the put liability is determined to be 12%. State by which amount the financial instrument will be recognised and under which category.

Solution

On 1 January 20X1, the present value of the (estimated) exercise price is ₹ 797 (₹ 1,000 discounted over 2 years at 12%).

Accordingly, P will recognise a financial liability of ₹ 797 and the difference between cash received i.e. ₹ 1000 and the financial liability of ₹ 797 will be debited to equity.

*****

2.4 SETTLEMENT IN ENTITY'S OWN EQUITY INSTRUMENTS

A financial instrument is classified as a liability not just when there is an obligation to deliver cash or another financial asset. It is **sometimes** so classified even when the entity's obligation is to settle the instrument through delivery of its own equity instruments.

Let us evaluate two alternate situations for an instrument that is convertible at the option of the issuer:

Illustration 14: Conversion into a number of equity instruments equivalent to a fixed value

CBA Ltd. issues convertible debentures to RQP Ltd. for a subscription amount of ₹ 100 crores. Those debentures are convertible after 5 years into equity shares of CBA Ltd. using a pre-determined formula. The formula is:

$$\frac{100 \text{ crores } X \ (1+10\%)^5}{\text{Fair value on date of conversion}}$$

Examine the nature of the financial instrument.

Solution

Such a contract is a financial liability of the entity even though the entity can settle it by delivering its own equity instruments. It is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract. The underlying thought behind this conclusion is that the entity is using its own equity instruments 'as currency'.

*****

Illustration 15: Conversion into a fixed number of equity instruments

DF Ltd. issues convertible debentures to JL Ltd. for a subscription amount of ₹ 100 crores. Those debentures are convertible after 5 years into 15 crore equity shares of ₹ 10 each.

Examine the nature of the financial instrument.

Solution

This contract is an equity instrument because changes in the fair value of equity shares arising from market related factors do not affect the amount of cash or other financial assets to be paid or received, or the number of equity instruments to be received or delivered.

From the above two situations, we can conclude as below:

- A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. **If an entity has a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligation, such a contract is a financial liability**. Such a contractual right or obligation may be for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments (eg an interest rate, a commodity price or a financial instrument price). (Ind AS 32.21). The number of equity instruments to be delivered could vary as a result of entity's own share price. [Ind AS 32.AG27(d)]

- **A contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument**. (Ind AS 32.22)

The above requirements are summarised in the table below:

S. No.	Consideration for financial instrument	Number of own equity instruments to be issued in settlement	Classification and rationale
1	Fixed	Variable	Financial liability – own equity instruments are being used as currency to settle an obligation for a fixed amount
2	Fixed	Fixed	Equity – issuer does not have an obligation to pay cash and holder is not exposed to any variability
3	Variable	Fixed	Financial liability – though issuer does not have an obligation to pay cash, but holder is exposed to variability
4	Variable	Variable	Financial liability – though issuer does not have an obligation to pay cash, but both parties are exposed to variability

The principle at serial number 2 in table above is also called **"fixed for fixed" test** i.e. fixed amount of cash or other financial asset for fixed number of own equity instruments.

Another point to note is a fine distinction highlighted in the definition of financial liability and equity, as mentioned in the paragraph "Definitions – financial liability and equity". Being mirror images of each other, for simplicity sake, let us look at condition (B) in the definition of "financial liability":

"An instrument that will or may be settled in the entity's own equity instruments and is:

i. a **non-derivative** for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

ii. a **derivative** that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments."

Please note the highlighted words in the definition. Illustration 12 and 13 above depict the classification of a non-derivative instrument. A derivative instrument, on the other hand, inter alia, would involve little initial net investment. The following example illustrates the context in which the aforementioned definition is to be read.

*****

Illustration 16: Written option for a fixed or variable number of equity instruments

ST Ltd. purchases an option from AT Ltd. entitling the holder to subscribe to equity shares of issuer at a fixed exercise price of ₹ 50 per share at any time during a period of 3 months. Holder paid an initial premium of ₹ 2 per option. Examine whether the financial instrument will be classified as equity.

Solution

For the issuer AT Ltd., this option is an equity instrument as it will be settled by the exchange of a fixed amount of cash for a fixed number of its own equity instruments.

If, on the other hand, if the exercise price of the option was variable, say benchmarked to an index or a variable, other than the market price of equity shares of AT Ltd., the written option will be classified as a "financial liability" in the books of the issuer, AT Ltd.

*****

For more discussion on derivative instruments, refer Unit 5: Derivatives and Embedded derivatives.

In the above illustration, if the instrument is classified as "equity instrument", any consideration received (such as the premium received for a written option or warrant on the entity's own shares) is added directly to equity. It must also be noted that changes in the fair value of an equity instrument are not recognised in the financial statements. (Ind AS 32.22)

On the contrary, if the derivative instrument (i.e. the written option) is classified as "financial liability", any consideration received is measured initially at fair value and subsequently also at fair value, with fair value changes recognised in profit or loss. For detailed discussion on measurement of financial liabilities, refer Unit 3.

The chart below summarises the discussion above:

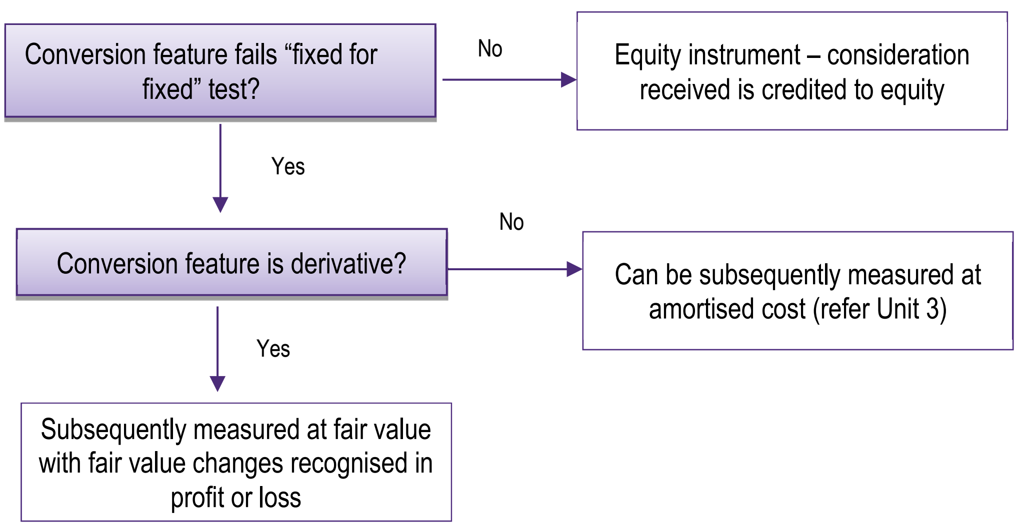


Illustration 17: Written option with multiple exercise prices

WC Ltd. writes an option in favour of GT Ltd. wherein the holder can purchase issuer's equity instruments at prices that fluctuate in response to the share price of issuer.

As per the terms, if the share price of issuer is less than ₹ 50 per share, option can be exercised at ₹ 40 per share. If the share price is equal to or more than ₹ 50 per share, option can be exercised at ₹ 60 per share. Explain the nature of the financial instrument.

Solution

As the contract will be settled by delivery of fixed number of instruments for a variable amount of cash, it is a financial liability.

*****

Illustration 18: Share swap arrangements

Acquirer Ltd. enters into an arrangement with shareholders of Target Ltd. wherein Acquirer Ltd. will purchase shares of Target Ltd. in a share swap arrangement against a variable amount of cash i.e. market value of Target Ltd.'s equity shares. The share swap ratio is agreed as 1:5 i.e. 1 equity share of Acquirer Ltd. for every 5 equity shares held in Target Ltd. Examine whether the financial instrument will be classified as equity.

Solution

Such arrangements will not meet the condition for classification as "equity instrument" since the contract will be settled by delivery of fixed number of Acquirer Ltd.'s own equity instruments against a variable amount of cash i.e. market value of Target Ltd.'s equity shares.

Such a contract will likely result in a derivative liability or asset for both the parties.

*****

Illustration 19: Conversion ratio changes with time

On 1 January 20X1, NKT Ltd. subscribes to convertible preference shares of VT Ltd. The conversion ratio varies as below:

Conversion upto 31 March 20X1: 1 equity share of VT Ltd. for each preference share held

Conversion upto 30 June 20X1: 1.5 equity share of VT Ltd. for each preference share held

Conversion upto 31 December 20X1: 2 equity share of VT Ltd. for each preference share held.

Examine whether the financial instrument will be classified as equity.

Solution

The convertible preference shares can be classified as "equity instrument" in the books of the issuer, VT Ltd. The conversion ratio doesn't change corresponding to any underlying variable, it only varies in response to passage of time which is a certain event and hence fixed.

*****

Illustration 20: Conversion ratio changes to protect rights of convertible instrument holders

On 1 January 20X1, HT Ltd. subscribes to convertible preference shares of RT Ltd. The preference shares are convertible in the ratio of 1:1.

The terms of the instrument entitle HT Ltd. to proportionately more equity shares of RT Ltd. in case of a stock split or bonus issue. Examine whether the financial instrument will be classified as equity.

Solution

The convertible preference shares can be classified as "equity instrument" in the books of the issuer, RT Ltd. The variability in the conversion ratio is only to protect the rights of the holder of convertible instrument vis-à-vis other equity shareholders.

The conversion was always intended to be in a fixed ratio and hence the holder is exposed to the change in equity value. The variability is brought in to maintain holder's exposure in line with other holders.

*****

Illustration 21: Conversion ratio changes if issuer subsequently issues shares to others at a lower price

On 1 January 20X1, PG Ltd. subscribes to convertible preference shares of BG Ltd. at ₹ 100 per preference share. The preference shares are convertible in the ratio of 10:1 i.e. 10 equity shares for each preference share held. On a fully diluted basis, PG Ltd. is entitled to 30% stake in BG Ltd.

If subsequent to the issuance of these convertible preference shares, BG Ltd. issues any equity instruments at a price lower than ₹ 10 per share, conversion ratio will be changed to compensate PG Ltd. for dilution in its stake below the expected dilution at a price of ₹ 10 per share. Examine the nature of the financial instrument.

Solution

The convertible preference shares will be classified as "financial liability" in the books of the issuer, BG Ltd. The variability in the conversion ratio underwrites the return on preference shares and not just protects the rights of convertible instrument holders vis-à-vis equity shareholders.

*****

Illustration 22: Conversion ratio is variable in a narrow range

On 1 January 20X1, NG Ltd. subscribes to convertible preference shares of AG Ltd. at ₹ 100 per preference share. On a fully diluted basis, NG Ltd. is entitled to 30% stake in AG Ltd.

The preference shares are convertible at fair value, subject to, NG Ltd.'s stake not going below 15% and not going above 40%. Examine the nature of the financial instrument.

Solution

The convertible preference shares will be classified as "financial liability" in the books of the issuer, AG Ltd. The variability in the conversion ratio underwrites the return on preference shares to an extent and also restricts that return. The preference shareholder is not entitled to residual net assets of the issuer.

In certain situations, an instrument is convertible only at the option of issuer. While such instruments provide the issuer with an unconditional right to avoid payment of cash, it is important to understand the economic substance of the option. It is also very important to determine whether the option is exercised by the issuer or by shareholders acting in their capacity as instrument holders.

For example, if the convertible instrument is held by the equity shareholders of the issuer and the conversion requires unanimous consent of all the shareholders, it would be inappropriate to consider that the issuer has an unconditional right to avoid payment of cash. In this situation, it would be more relevant to consider the rights of the instrument holders in their capacity as equity shareholders of the issuer.

*****

Illustration 23: Instrument convertible only at the option of issuer

XYZ Ltd. issues optionally convertible debentures with the following terms:

The debentures carry interest at the rate of 7% p.a.

Issuer has option to either:

Convert the instrument into a fixed number of its own shares at any time, or redeem the instrument in cash at any time. The redemption price is the fair value of the fixed number of shares into which the instrument would have converted if it had been converted.

The holder has no conversion or redemption options.

Debentures have a tenor of 12 years and, if not converted or redeemed earlier, will be repaid in cash at maturity, including accrued interest, if any.

Examine the nature of the financial instrument.

Solution

The issuer has the ability to convert the debentures into a fixed number of its own shares at any time. The issuer, therefore, has the ability to avoid making a cash payment or settling the debentures in a variable number of its own shares. Therefore, such a financial instrument is likely to be classified as equity.

However, it must be noted that mere existence of a right to avoid payment of cash is not conclusive. The instrument is to be accounted for as per its substance and hence it needs to be seen whether the conversion option is substantive.

In this particular situation, the issuer will need to determine whether it is favourable to exercise the conversion option or redemption option. In case of latter, the instrument will be classified as a financial liability (a hybrid instrument, whose measurement is dealt with in a subsequent section).

Practical situations do arise wherein the issuer has an option or obligation to issue own equity instruments only in particular circumstances i.e. the instrument is contingently convertible.

*****

Illustration 24: Conversion ratio changes under independent scenarios

On 1 January 20X1, STAL Ltd. subscribes to convertible preference shares of ATAL Ltd.

The preference shares are convertible as below:

Convertible 1:1 if another strategic investor invests in the issuer within one year

Convertible 1.5:1: if an IPO is successfully completed within 2 years

Convertible 2:1: if a binding agreement for sale of majority stake by equity shareholders is entered into within 3 years

Convertible 3:1: if none of these events occur in 3 years' time.

Examine whether the financial instrument will be classified as equity.

Solution

In this case the four events can be viewed as discrete because the achievement of each one of these can occur independently of the other (as they relate to different periods). The arrangement can therefore be considered to be economically equivalent to four separate contracts. The price per share and the amount of shares to be issued is fixed in each of these discrete periods, with each event relating to a different year and therefore a separate risk. The "fixed for fixed" test is therefore met.

The instrument is therefore classified as "equity instrument".

*****

Illustration 25: Conversion ratio changes under inter-dependent scenarios

On 1 January 20X1, RHT Ltd. subscribes to convertible preference shares of RDT Ltd.

The preference shares are convertible as below:

Convertible 1:1 if another strategic investor invests at an enterprise valuation (EV) of USD 100 million.

Convertible 1.5:1: if another strategic investor invests at EV of USD 150 million

Convertible 2:1: if another strategic investor invests at EV of USD 200 million

Convertible 3:1: if no strategic investment is made within a period of 3 years

Examine the nature of the financial instrument.

Solution

The four events are interdependent because the second event cannot be met without also meeting the first event, and the third event cannot be met unless the first two are met.

Therefore, this contract should be treated as a single instrument when applying the "fixed for fixed" test. The test is then failed because the number of shares to be exchanged for cash are variable.

*****

2.4.1 Settlement Options

When a derivative financial instrument gives one party a choice over how it is settled, it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument. (Ind AS 32.26)

For instance - a share option that the issuer can decide to settle net in cash or by exchanging its own shares for cash is a financial liability.

2.4.2 Settlement by delivery of instruments that meet conditions for exceptions to classification as financial liability

If the entity's own equity instruments to be received, or delivered, by the entity upon settlement of a contract are:

- puttable financial instruments with all the features and meeting the conditions described in paragraphs 16A and 16B of Ind AS 32 (as discussed above), or
- instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation with all the features and meeting the conditions described in paragraphs 16C and 16D of Ind AS 32 (as discussed above),

the contract is a financial asset or a financial liability.

This includes a contract that will be settled by the entity receiving or delivering a fixed number of such instruments in exchange for a fixed amount of cash or another financial asset. (Ind AS 32.22A)

2.4.3 Rights issues, options or warrants to acquire entity's own equity instruments for any currency

Rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. (Ind AS 32.11)

Carve out from IFRS: Equity conversion option embedded in a foreign currency convertible bond

Ind AS 32 considers the equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of entity's own equity instruments as an equity instrument if the exercise price is fixed in any currency.

Let's understand this carve-out from IFRS using an illustration:

Illustration 26: Foreign currency convertible bond

Entity A issues a bond with face value of USD 100 and carrying a fixed coupon rate of 6% p.a. Each bond is convertible into 1,000 equity shares of the issuer. Examine the nature of the financial instrument.

Solution

While the number of equity shares is fixed, the amount of cash is not. The variability in cash arises on account of fluctuation in exchange rate of INR-USD. Such a foreign currency convertible bond (FCCB) will qualify the definition of "financial liability".

However, Ind AS 32.11 provides, "the equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of the entity's own equity instruments is an equity instrument if the exercise price is fixed in any currency."

Accordingly, FCCB will be treated as an "equity instrument".

*****

2.5 COMPOUND FINANCIAL INSTRUMENTS

So far we have discussed two broad aspects of classification:

- Obligations to deliver cash – generally, instruments with such obligations are classified as "financial liability"
- Settlement in own equity instruments – generally, instruments with such provisions are classified as "equity"

There are several exceptions to the general principles stated above, as we have seen in several illustrations discussed so far.

Let us now study those instruments which have features of both a financial liability and equity instrument. Such instruments are called "compound financial instruments". This topic is aimed at discussing the accounting treatment of such instruments and practical complexities that are arise due to issuance of such instruments.

The following illustrations demonstrate the identification of separate components of a financial instrument and determining whether it is a compound financial instrument.

Illustration 27: Redeemable debentures with discretionary dividend (continued from Illustration 2)

X Co. Ltd. (issuer) issues debentures to Y Co. Ltd. (holder). Those debentures are redeemable at the end of 10 years from the date of issue. Interest of 15% p.a. is payable at the discretion of the issuer. The rate of interest is commensurate with the credit risk profile of the issuer. Examine the nature of the financial instrument.

Solution

This instrument has two components – (1) mandatory redemption by the issuer for a fixed amount at a fixed future date, and (2) interest payable at the discretion of the issuer.

The first component is a contractual obligation to deliver cash (for repayment of principal with or without premium, as per terms) to the debenture holder that cannot be avoided. This component of the instrument is a financial liability.

The other component, discretionary interest is an equity feature because issuer can avoid payment of cash or another financial asset in this respect.

Therefore, this instrument is concluded to be a compound financial instrument.

*****

Illustration 28: Perpetual loan with mandatory interest (continued from Illustration 3)

P Co. Ltd. (issuer) takes a loan from Q Co. Ltd. (holder). The loan is perpetual and entitles the holder to fixed interest of 8% p.a. Examine the nature of the financial instrument.

Solution

This instrument has two components – (1) mandatory interest by the issuer for a fixed amount at a fixed future date, and (2) perpetual nature of the principal amount.

The first component is a contractual obligation to deliver cash (for payment of interest) to the lender that cannot be avoided. This component of the instrument is a financial liability.

The other component, perpetual principal, is an equity feature because issuer is not required to pay cash or another financial asset in this respect.

Therefore, this instrument is concluded to be a compound financial instrument.

*****

Illustration 29: Optionally convertible redeemable preference shares (continued from Illustration 5)

D Ltd. issues preference shares to G Ltd. The holder has an option to convert these preference shares to equity instruments of the issuer anytime up to a period of 10 years. If the option is not exercised by the holder, the preference shares are redeemed at the end of 10 years. Examine the nature of the financial instrument.

Solution

This instrument has two components – (1) contractual obligation that is conditional on holder exercising its right to redeem, and (2) conversion option with the holder.

The first component is a financial liability because the entity does not have the unconditional right to avoid delivering cash.

The other component, conversion option with the holder, is an equity feature if the "fixed for fixed" test is satisfied. If the conversion option does not fulfil that test, say, because the conversion ratio varies in response to an underlying variable, it is a derivative liability.

Such an instrument is called a "hybrid instrument".

*****

2.5.1 Split accounting for compound financial instruments

Ind AS 109 deals with the measurement of financial assets and financial liabilities. Equity instruments are instruments that evidence a residual interest in the assets of an entity after deducting all of its liabilities. Therefore, when the initial carrying amount of a compound financial instrument is allocated to its equity and liability components:

- the equity component is assigned the residual amount i.e.
  - ♦ fair value of the instrument as a whole, *less*
  - ♦ the amount separately determined for the liability component.
- The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the fair value that would be ascribed to the instrument as a whole.
- No gain or loss arises from initially recognising the components of the instrument separately.

(Ind AS 32.31)

In Illustrations 28 and 29 above, split accounting is performed by first determining the carrying amount of the liability component. This is done by measuring the net present value of the discounted cash flows of interest and/or principal, ignoring the possibility of exercise of the conversion option, if any. The discount rate is the market rate at the time of inception for a similar liability that does not have an associated equity component. The carrying amount of the equity instrument represented by perpetual principal in Illustration 28 and conversion option in Illustration 29 is then determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole.

Illustration 30: Perpetual loan with mandatory interest (continued from Illustration 3)

P Co. Ltd. (issuer) takes a loan from Q Co. Ltd. (holder) for ₹ 12 lakhs. The loan is perpetual and entitles the holder to fixed interest of 8% p.a. The rate of interest commensurate with credit risk profile of the issuer is 12% p.a. Calculate the value of the liability and equity components.

Solution

The values of the liability and equity components are calculated as follows:

Present value of interest payable in perpetuity (₹ 96,000 discounted at 12%) = ₹ 800,000

Therefore, equity component = fair value of compound instrument, say, ₹ 1,200,000 less financial liability component i.e. ₹ 800,000 = ₹ 400,000.

In subsequent years, the profit and loss account is charged with interest of 12% on the debt instrument.

*****

Illustration 31: Optionally convertible redeemable preference shares (continued from Illustration 29)

On 1 July 20X1, D Ltd. issues preference shares to G Ltd. for a consideration of ₹ 10 lakhs. The holder has an option to convert these preference shares to a fixed number of equity instruments of the issuer anytime up to a period of 3 years. If the option is not exercised by the holder, the preference shares are redeemed at the end of 3 years. The preference shares carry a fixed coupon of 6% p.a. The prevailing market rate for similar preference shares, without the conversion feature, is 9% p.a.

Calculate the value of the liability and equity components.

Solution

The values of the liability and equity components are calculated as follows:

Present value of principal payable at the end of 3 years (₹ 10 lakhs discounted at 9% for 3 years) = ₹ 772,183

Present value of interest payable in arrears for 3 years (₹ 60,000 discounted at 9% for each of 3 years) = ₹ 151,878

Total financial liability = ₹ 924,061

Therefore, equity component = fair value of compound instrument, say, ₹ 1,000,000 less financial liability component i.e. ₹ 924,061 = ₹ 75,939.

In subsequent years, the profit and loss account is charged with interest of 9% on the debt instrument.

*****

2.5.2 Separation of non-equity embedded derivatives

Sometimes, the issuer also has the option to early redeem the instrument mentioned in Illustration 31. Such an option is issuer's call option. This call option is considered an embedded derivative which is a financial liability. The value of any derivative features (such as a call option) embedded in the compound financial instrument other than the equity component (such as an equity conversion option) is included in the liability component. (Ind AS 32.31)

Illustration 32: Optionally convertible preference shares with issuer's redemption option

D Ltd. issues preference shares to G Ltd. for a consideration of ₹ 10 lakhs. The holder has an option to convert these preference shares to a fixed number of equity instruments of the issuer anytime up to a period of 3 years. If the option is not exercised by the holder, the preference shares are redeemed at the end of 3 years. The preference shares carry a coupon of RBI base rate plus 1% p.a.

The prevailing market rate for similar preference shares, without the conversion feature or issuer's redemption option, is RBI base rate plus 4% p.a. On the date of contract, RBI base rate is 9% p.a.

Calculate the value of the liability and equity components.

Solution

The values of the liability and equity components are calculated as follows:

Present value of principal payable at the end of 3 years (₹ 10 lakhs discounted at 13% for 3 years) = ₹ 6,93,050

Present value of interest payable in arrears for 3 years (₹ 100,000 discounted at 13% for each of 3 years) = ₹ 2,36,115

Paragraph AG 31 of Ind AS 32 states that a common form of compound financial instruments is a debt instrument with an embedded conversion option, such as a bond convertible into ordinary shares of the issuer, and without any other embedded derivatives features.

The liability component = Present value of principal + Present value of Interest

= ₹ 6,93,050 + ₹ 2,36,115 = ₹ 9,29,165

Equity Component = ₹ 10,00,000 – ₹ 9,29,165 = ₹ 70,835

*****

2.5.3 Conversion or early settlement of compound financial instruments

2.5.3.1 Conversion

Classification of the liability and equity components of a convertible instrument is not revised as a result of a change in the likelihood that a conversion option will be exercised, even when exercise of the option may appear to have become economically advantageous to some holders. Holders may not always act in the way that might be expected because, for example, the tax consequences resulting from conversion may differ among holders. Furthermore, the likelihood of conversion will change from time to time. The entity's contractual obligation to make future payments remains outstanding until it is extinguished through conversion, maturity of the instrument or some other transaction. (Ind AS 32.30)

On conversion of a convertible instrument at maturity, the entity:

- derecognises the liability component and
- recognises it as equity.
- original equity component remains as equity (although it may be transferred from one line item within equity to another).
- there is no gain or loss on conversion at maturity.

2.5.3.2 Early settlement

When an entity extinguishes a convertible instrument before maturity through an early redemption or repurchase in which the original conversion privileges are unchanged, the entity allocates the consideration paid and any transaction costs for the repurchase or redemption to the liability and equity components of the instrument at the date of the transaction. The method used in allocating the consideration paid and transaction costs to the separate components is consistent with that used in the original allocation to the separate components of the proceeds received by the entity when the convertible instrument was issued. (Ind AS 32.AG33)

In other words, the issuer:

- starts by **allocating the settlement price to the remaining liability** i.e. it determines the fair value of the remaining liability using a discount rate that is based on circumstances at the settlement date (this rate may differ from the rate used for the original allocation), and
- allocates the residual settlement amount to the equity component.

As per Ind AS 32.AG34, once the allocation of the consideration is made, any resulting gain or loss is treated in accordance with accounting principles applicable to the related component, as follows:

a) the amount of gain or loss relating to the liability component is recognised in profit or loss; and

b) the amount of consideration relating to the equity component is recognised in equity.

Illustration 33: Optionally convertible redeemable preference shares (continued from Illustration 31)

The amortisation schedule of the instrument is set out below:

Dates	*Cash flows*	*Finance cost at effective interest rate*	*Liability*	*Equity*
1July 20X1	*1,000,000*	*-*	*9,24,061*	*75,939*
30 June 20X2	*(60,000)*	*83,165*	*9,47,226*	*75,939*
30 June 20X3	*(60,000)*	*85,250*	*9,72,476*	*75,939*
30 June 20X4	*(10,60,000)*	*87,524*	*-*	*75,939*

Assume that D Ltd. has an early redemption option to prepay the instrument at ₹ 11 lakhs and on 30 June 20X3, it exercises that option. At 30 June 20X3, the interest rate has changed. At that time, D Ltd. could have issued a one-year (i.e. maturity 30 June 20X4) non-convertible instrument at 5%. Calculate the value of the liability and equity components.

Solution

Ind AS 32 requires that the amount paid (of ₹ 11 lakhs) is split by the same method as is used in the initial recording. However, at 30 June 20X3, the interest rate has changed. At that time, D Ltd. could have issued a one-year (i.e. maturity 30 June 20X4) non-convertible instrument at 5%.

The split will be made as below:

Particulars	Amount (₹)
Present value of principal payable at 30 June 20X4 in one year's time (₹ 10 lakhs discounted at 5% for one year)	9,52,381
Present value of interest payable (₹ 60,000 discounted at 5% for one year)	57,142
Total liability component	10,09,523
Consideration paid	11,00,000
Residual – equity component	90,477

Accordingly, the difference between consideration allocated to liability component (₹ 10,09,523) less carrying amount of financial liability on date of redemption i.e. 30 June 20X3 (₹ 9,72,476), amounting to ₹ 37,047 is recognised in profit or loss.

The residual i.e. consideration allocated to equity component is debited to equity.

*****

An entity may amend the terms of a convertible instrument to induce early conversion, for example by offering a more favourable conversion ratio or paying other additional consideration in the event of conversion before a specified date.

The difference, at the date the terms are amended, between:

- the fair value of the consideration the holder receives on conversion of the instrument under the revised terms and

- the fair value of the consideration the holder would have received under the original terms is recognised as a loss in profit or loss.

2.6 TREASURY SHARES

If an entity reacquires its own equity instruments:

- Consideration paid for those instruments ('treasury shares') shall be deducted from equity. An entity's own equity instruments are not recognised as a financial asset regardless of the reason for which they are reacquired.
- Consideration received shall be recognised directly in equity.
- No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments

In the consolidated financial statements, consideration for treasury shares acquired and held by other members of the consolidated group, is deducted from equity.

It may be noted that when an entity holds its own equity on behalf of others, eg a financial institution holding its own equity on behalf of a client, there is an agency relationship and as a result those holdings are not included in the entity's statement of financial position.

2.7 INTEREST, DIVIDENDS, LOSSES AND GAINS

The accounting principles related to transactions arising consequent to recognition of financial instruments are summarised below (Ind AS 32.35-41):

- The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends, losses and gains relating to that instrument are recognised as income or expense in profit or loss.
    - ♦ Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss.
    - ♦ Distributions to holders of an equity instrument shall be recognised by the entity directly in equity.
- **Transaction costs:**
    - ♦ Equity transaction – accounted for as a deduction from equity to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided. The costs of an equity transaction that is abandoned are recognised as an expense.
    - ♦ Compound financial instrument – allocated to the liability and equity components of the instrument in proportion to the allocation of proceeds.

- Income tax relating to distributions to holders of an equity instrument and to transaction costs of an equity transaction shall be accounted for in accordance with Ind AS 12 Income Taxes
- Changes in the fair value of an equity instrument are not recognised in the financial statements.
- **Presentation:**
  - The amount of transaction costs accounted for as a deduction from equity in the period is disclosed separately in accordance with Ind AS 1.
  - Dividends classified as an expense may be presented in the statement of comprehensive income either with interest on other liabilities or as a separate item.
  - Gains and losses related to changes in the carrying amount of a financial liability are recognised as income or expense in profit or loss even when they relate to an instrument that includes a right to the residual interest in the assets of the entity in exchange for cash or another financial asset.

2.8 OFFSETTING A FINANCIAL ASSET AND A FINANCIAL LIABILITY

In many situations, an entity has the right to receive or pay a single net amount in relation to two or more separate financial instruments and intends to do so as well.

As per Ind AS 32.42 and Ind AS 32.AG38A, a financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position when, and only when, an entity:

a) currently has a **legally enforceable right to set off** the recognised amounts – this means that the right of set off:

   i. must not be contingent on a future event; and

   ii. must be legally enforceable in the normal course of business, in the event of default and in the event of insolvency or bankruptcy of the entity and all of the counterparties.

b) **intends** either to settle on a net basis, or to realise the asset and settle the liability simultaneously - If an entity can settle amounts in a manner such that the outcome is, in effect, equivalent to net settlement, the entity will meet the net settlement criterion. This will occur if, and only if, the gross settlement mechanism has features that eliminate or result in insignificant credit and liquidity risk, and that will process receivables and payables in a single settlement process or cycle.

Offsetting a recognised financial asset and a recognised financial liability and presenting the net amount differs from the derecognition of a financial asset or a financial liability. Although offsetting does not give rise to recognition of a gain or loss, the derecognition of a financial instrument not only results in the removal of the previously recognised item from the statement of financial position but also may result in recognition of a gain or loss. (Ind AS 32.44).

A right of set-off is a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor. In unusual circumstances, a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor provided that there is an agreement between the three parties that clearly establishes the debtor's right of set-off. (Ind AS 32.45).

The conditions set out above are generally not satisfied and offsetting is usually inappropriate when (Ind AS 32.49):

a) several different financial instruments are used to emulate the features of a single financial instrument (a 'synthetic instrument') - For example, a floating rate long-term debt combined with an interest rate swap that involves receiving floating payments and making fixed payments synthesises a fixed rate long-term debt:

   i. Each of the individual financial instruments that together constitute a 'synthetic instrument' represents a contractual right or obligation with its own terms and conditions

   ii. Each may be transferred or settled separately.

   iii. Each financial instrument is exposed to risks that may differ from the risks to which other financial instruments are exposed.

   Accordingly, when one financial instrument in a 'synthetic instrument' is an asset and another is a liability, they are not offset and presented in an entity's statement of financial position on a net basis unless they meet the criteria for offsetting.

b) financial assets and financial liabilities arise from financial instruments having the same primary risk exposure (for example, assets and liabilities within a portfolio of forward contracts or other derivative instruments) but involve different counterparties;

c) financial or other assets are pledged as collateral for non-recourse financial liabilities;

d) financial assets are set aside in trust by a debtor for the purpose of discharging an obligation without those assets having been accepted by the creditor in settlement of the obligation (for example, a sinking fund arrangement); or

e) obligations incurred as a result of events giving rise to losses are expected to be recovered from a third party by virtue of a claim made under an insurance contract.

QUICK RECAP

- Classification as a financial liability or as equity depends on the substance of a financial instrument rather than its legal form. The substance depends on the instrument's contractual rights and obligations.
- Liability classification - a financial instrument which contains a contractual obligation whereby the issuing entity is or may be required to deliver cash or another financial asset to the instrument holder

- There are certain rule-based exceptions to the basic principle for classification of an instrument as financial liability – puttable instruments and obligations arising only on liquidation
- Financial instrument containing a contingent settlement provision, under which the instrument would be classified as a financial liability on the occurrence or non-occurrence of some uncertain future event beyond the control of both the issuer and the holder – usually classified as a financial liability unless the part of the contingent settlement provision that indicates liability classification is not genuine; or the issuer can be required to settle the obligation in cash or another financial asset only in the event of liquidation of the issuer
- Instruments which may or will be settled in an entity's own equity instruments – apply "fixed for fixed" test
- Instruments with both equity and liability features are compound instruments – equity and liability components are accounted for separately ('split accounting')
- Split accounting involves first calculating the fair value of the liability component. The equity component is then determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole
- Subsequent changes in the value of the equity instruments are not recognised in the financial statements.
- The accounting implication of classification of a financial instrument as a financial liability or equity is given in table below:

Accounting aspect	Financial liability	Equity instrument
Re-measurement standard	Ind AS 109	Generally, not re-measured after initial measurement
Recognition of interest, dividends, losses and gains	Profit or loss	Retained earnings
Recognition of transaction costs	Included in calculation of effective interest rate and amortised over expected life of the instrument	Deduction from equity

UNIT 3: CLASSIFICATION AND MEASUREMENT OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

3.1 INTRODUCTION

Classification of financial assets and financial liabilities is done based on the underlying economic of the financial instrument. While all financial assets and financial liabilities are recognised at their fair value upon initial recognition, classification of the financial assets and financial liabilities drives their subsequent measurement.

3.2 FINANCIAL ASSETS: CLASSIFICATION – OVERALL CONCEPT

Categorisation of financial assets (FA) is determined based on the business model that determines how cash flows of the financial asset are collected and the contractual cash flow characteristics; and can be:

(a) Measured at **Amortised cost**

(b) Measured at fair value through comprehensive income (**FVOCI**)

(c) Measured at fair value through profit or loss (**FVTPL**).

- As per Ind AS 109.4.1.1 – Except for financial assets designated as fair value through profit or loss (refer Ind AS 109.4.1.5 below), an entity shall classify financial assets as subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss on the basis of both:

  (a) Entity's **business model** (BM) for managing the financial assets and

  (b) **Contractual cash flow** characteristics of the financial asset.

- Categorisation of financial assets has been broadly laid out in the below flow chart:

Financial Assets measured at

Amortised cost

If below conditions are met:

(a) FA is held with BM whose objective is to hold financial assets in order to collect contractual cash flows

(b) Contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

Fair value through Other Comprehensive Income

- FA shall be measured at FVOCI if below conditions are met:
  - (a) FA is held with BM whose objective is achieved both by collecting contractual cash flows and selling FA
  - (b) Contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding
- Any equity instruments for which the entity makes an irrevocable election to carry at fair value through OCI

Fair value through profit or loss

FA are accounted at FVTPL if:

(a) Any asset which is not measured at amortised cost and not measured at FVOCI; or

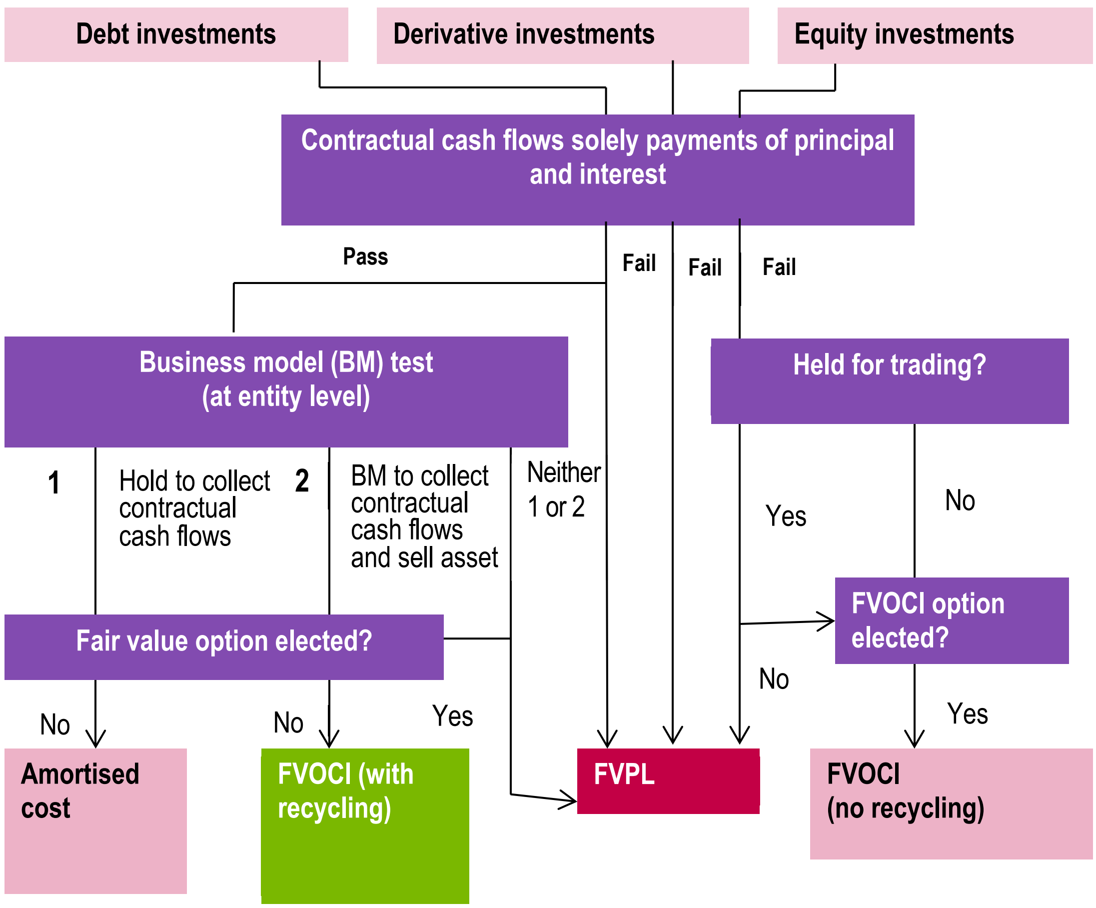
(b) If on initial recognition, any asset may irrevocably be designated as FVTPL if specific criteria met.

- **Exception to classification based on above criteria mentioned in para 109.4.1.1 – Option to designate at fair value through profit or loss:**

  An entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an **'accounting mismatch'**) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases

  The decision of an entity to designate a financial asset or financial liability as at fair value through profit or loss is similar to an accounting policy choice (although, unlike an accounting policy choice, it is not required to be applied consistently to all similar transactions). When an entity has such a choice, paragraph 14(b) of IAS 8 requires the chosen policy to result in the financial statements providing reliable and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows.

- **Based on above guidance, the decision tree for classification of financial assets can be understood with the help of following flow chart:**



3.3 FINANCIAL ASSETS: KEY ELEMENTS TO DETERMINE CLASSIFICATION

Key essential elements that determine classification of financial assets are:

(A) Business model (BM) test:

- An entity's business model refers to how an entity manages its financial assets in order to generate cash flows.

Factors determining BM	
	❖ An entity's business model for managing financial assets is a matter of fact and not merely an assertion. It is typically observable through the activities that the entity undertakes to achieve the objective of the business model and an entity will need to use judgement when it assesses its business model for managing financial assets. ❖ This assessment is not determined by a single factor or activity. Instead, the entity must consider all relevant evidence that is available. Such relevant evidence includes, but is not limited to: (a) how the performance of business model and the financial assets held within that business model are evaluated & reported to the entity's key management personnel; (b) the risks that affect the performance of the business model (and the financial assets held within that business model) and, in particular, the way in which those risks are managed; and (c) how managers of the business are compensated (for example, whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected).

Level of aggregation of assets for determining BM	❖ An entity's business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective and not based on management's intentions for an individual instrument. Accordingly, this condition is not an instrument-by-instrument approach to classification and should be determined on a higher level of aggregation. ❖ However, a single entity may have more than one business model for managing its financial instruments. Consequently, classification need not be determined at the reporting entity level. For example, an entity may hold a portfolio of investments that it manages in order to collect contractual cash flows and another portfolio of investments that it manages in order to trade to realise fair value changes.
Determining basis of realisation of contractual cash flows	❖ Entity's business model determines whether cash flows will result from collecting contractual cash flows, selling financial assets or both. Consequently, this assessment is not performed on the basis of scenarios that the entity does not reasonably expect to occur, such as so-called 'worst case' or 'stress case' scenarios. ❖ For example, if an entity expects that it will sell a particular portfolio of financial assets only in a stress case scenario, that scenario would not affect the entity's assessment of the business model for those assets if the entity reasonably expects that such a scenario will not occur.
Difference in actual realisation from BM	If cash flows are realised in a way that is different from the entity's expectations at the date that the entity assessed the business model (for example, if the entity sells more or fewer financial assets than it expected when it classified the assets), that does not give rise to a prior period error in the entity's financial statements nor does it change the classification of the remaining financial assets held in that business model (ie those assets that the entity recognised in prior periods and still holds) as long as the entity considered all relevant information that was available at the time that it made the business model assessment.

- **Financial assets held for trading:**

  Financial assets held for trading are defined as those that:

  (a) are acquired or incurred principally for the purpose of sale or repurchase in the near term;

  (b) on initial recognition are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or

  (c) are derivatives (except for those that are financial guarantee contracts or are designated effective hedging instruments).

  Trading generally reflects active and frequent buying and selling, and financial instruments held for trading are normally used with the objective of generating a profit from short-term fluctuations in price or a dealer's margin.

Illustration 1

An entity holds investments to collect their contractual cash flows. The funding needs of the entity are predictable and the maturity of its financial assets is matched to the entity's estimated funding needs.

The entity performs credit risk management activities with the objective of minimising credit losses. In the past, sales have typically occurred when the financial assets' credit risk has increased such that the assets no longer meet the credit criteria specified in the entity's documented investment policy. In addition, infrequent sales have occurred as a result of unanticipated funding needs.

Reports to key management personnel focus on the credit quality of the financial assets and the contractual return. The entity also monitors fair values of the financial assets, among other information.

Evaluate the business model.

Solution

- Although the entity considers, among other information, the financial assets' fair values from a liquidity perspective (ie the cash amount that would be realised if the entity needs to sell assets), the entity's objective is to hold the financial assets in order to collect the contractual cash flows.

- Sales would not contradict that objective if they were in response to an increase in the assets' credit risk, for example if the assets no longer meet the credit criteria specified in the entity's documented investment policy. Infrequent sales resulting from unanticipated funding needs (eg in a stress case scenario) also would not contradict that objective, even if such sales are significant in value.

Hence, the business model of the company is to collect contractual cash flows and not realisation from sale of financial assets.

*****

Illustration 2

An entity's business model is to purchase portfolios of financial assets, such as loans. Those portfolios may or may not include financial assets that are credit impaired.

If payment on the loans is not made on a timely basis, the entity attempts to realise the contractual cash flows through various means—for example, by contacting the debtor by mail, telephone or other methods. The entity's objective is to collect the contractual cash flows and the entity does not manage any of the loans in this portfolio with an objective of realising cash flows by selling them.

In some cases, the entity enters into interest rate swaps to change the interest rate on particular financial assets in a portfolio from a floating interest rate to a fixed interest rate.

Evaluate the business model.

Solution

The objective of the entity's business model is to hold the financial assets in order to collect the contractual cash flows. The same analysis would apply even if the entity does not expect to receive all of the contractual cash flows (eg some of the financial assets are credit impaired at initial recognition).

Moreover, the fact that the entity enters into derivatives to modify the cash flows of the portfolio does not in itself change the entity's business model.

*****

Illustration 3

Entity B sells goods to customers on credit. Entity B typically offers customers up to 60 days following the delivery of goods to make payment in full. Entity B collects cash in accordance *with the contractual cash flows of trade receivables and has no intention to dispose of the receivables.*

Evaluate the business model.

Solution

Entity's B objective is to collect contractual cash flows from trade receivables and therefore, trade receivables meet the business model test for the purpose of classifying the financial assets at amortised cost.

*****

Illustration 4

An entity anticipates capital expenditure in a few years. The entity invests its excess cash in short and long-term financial assets so that it can fund the expenditure when the need arises. Many of the financial assets have contractual lives that exceed the entity's anticipated investment period.

The entity will hold financial assets to collect the contractual cash flows and, when an opportunity arises, it will sell financial assets to re-invest the cash in financial assets with a higher return. The managers responsible for the portfolio are remunerated based on the overall return generated by the portfolio.

Evaluate the business model.

Solution

The objective of the business model is achieved by both collecting contractual cash flows and selling financial assets. The entity will make decisions on an ongoing basis about whether collecting contractual cash flows or selling financial assets will maximise the return on the portfolio until the need arises for the invested cash.

In contrast, consider an entity that anticipates a cash outflow in five years to fund capital expenditure and invests excess cash in short-term financial assets. When the investments mature, the entity reinvests the cash in new short-term financial assets. The entity maintains this strategy until the funds are needed, at which time the entity uses the proceeds from the maturing financial assets to fund the capital expenditure. Only sales that are insignificant in value occur before maturity (unless there is an increase in credit risk). The objective of this contrasting business model is to hold financial assets to collect contractual cash flows.

*****

Illustration 5

An entity has a business model with the objective of originating loans to customers and subsequently selling those loans to a securitisation vehicle. The securitisation vehicle issues instruments to investors. The originating entity controls the securitisation vehicle and thus consolidates it.

The securitisation vehicle collects the contractual cash flows from the loans and passes them on to its investors. In the consolidated balance sheet, loans continue to be recognised because they are not derecognised by the securitisation vehicle.

Evaluate the business model.

Solution

The entity originating loans to customers has the objective of realising contractual cash flows on the loan portfolio only through sale to securitisation vehicle. However, the consolidated group originates loans with the objective of holding them to collect the contractual cash flows.

- Hence, the consolidated financial statements provide for a business model with the objective of collecting contractual cash flows by holding to maturity.
- And in separate financial statements of the entity originating loans to customers, business model is to collect cash flows through sale only.

*****

Illustration 6

A financial institution holds financial assets to meet liquidity needs in a 'stress case' scenario (eg, a run on the bank's deposits). The entity does not anticipate selling these assets except in such scenarios. The entity monitors the credit quality of the financial assets and its objective in managing the financial assets is to collect the contractual cash flows. The entity evaluates the performance of the assets on the basis of interest revenue earned and credit losses realised.

However, the entity also monitors the fair value of the financial assets from a liquidity perspective to ensure that the cash amount that would be realised if the entity needed to sell the assets in a stress case scenario would be sufficient to meet the entity's liquidity needs. Periodically, the entity makes sales that are insignificant in value to demonstrate liquidity.

Evaluate the business model.

Solution

The objective of the entity's business model is to hold the financial assets to collect contractual cash flows. The analysis would not change –

- If during a previous stress case scenario the entity had sales that were significant in value in order to meet its liquidity needs; or
- Recurring sales activity that is insignificant in value is not inconsistent with holding financial assets to collect contractual cash flows; or
- If the entity is required by its regulator to routinely sell financial assets to demonstrate that the assets are liquid, and the value of the assets sold is significant, the entity's business model is not to hold financial assets to collect contractual cash flows. Whether a third party imposes the requirement to sell the financial assets, or that activity is at the entity's discretion, is not relevant to the analysis.

In contrast, if an entity holds financial assets to meet its everyday liquidity needs and meeting that objective involves frequent sales that are significant in value, the objective of the entity's business model is not to hold the financial assets to collect contractual cash flows.

*****

(B) Contractual cash flows characteristics test:

Ind AS 109.4.1.1(b) requires an entity to classify a financial asset on the basis of its contractual cash flow characteristics if the financial asset is held –

i. within a business model whose objective is to hold assets to collect contractual cash flows; or

ii. within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

To do so, an entity is required to determine whether the asset's contractual cash flows are solely payments of principal and interest on the principal amount outstanding for the currency in which the financial asset is denominated.

- The key characteristics of cash flows to test if they are solely payments of principal and interest are as follows:

What is principal?	❖ Principal is the fair value of the financial asset at initial recognition. ❖ However, that principal amount may change over the life of the financial asset (for example, if there are repayments of principal).

Components of 'interest element'	**Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement**. An originated or a purchased financial asset can be a basic lending arrangement irrespective of whether it is a loan in its legal form. ❖ In a basic lending arrangement, consideration for the time value of money and credit risk are typically the most significant elements of interest. ❖ However, in such an arrangement, interest can also include – ❖ consideration for other basic lending risks (for example, liquidity risk); ❖ costs (for example, administrative costs) associated with holding the financial asset for a particular period of time; and ❖ profit margin that is consistent with a basic lending arrangement. ❖ In extreme economic circumstances, interest can be negative if, for example, the holder of a financial asset either explicitly or implicitly pays for the deposit of its money for a particular period of time (and that fee exceeds the consideration that the holder receives for the time value of money, credit risk and other basic lending risks and costs). ❖ However, contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are solely payments of principal & interest. ❖ Leverage is a contractual cash flow characteristic of some financial assets, that increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Stand-alone option, forward and swap contracts are examples of financial assets that include such leverage. Thus, such contracts cannot be said to have contractual cash flows that are only payments of principal & interest and hence, cannot be subsequently measured at amortised cost or fair value through other comprehensive income.

- Following are **examples** of contractual terms that result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding:

  (a) a variable interest rate on a financial instrument, where this rate consists of consideration for –

  - time value of money,
  - credit risk associated with the principal amount outstanding during a particular period of time (the consideration for credit risk may be determined at initial recognition only, and so may be fixed); and
  - other basic lending risks and costs, as well as a profit margin.

  This is because this variable interest rate is only to provide the lender with a return through 'interest' based on present market factors and no other form of return on the principal amount of the financial instrument. So, it has characteristics of return similar to one on a basic lending arrangement and thus, meets definition of contractual cash flows that are solely payments of principal and interest.

  (b) a contractual term that permits the issuer (ie the debtor) to prepay a debt instrument or permits the holder (ie the creditor) to put a debt instrument back to the issuer before maturity and the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract;

  Reasonable additional compensation' implies that the party choosing to exercise its option to terminate the contract compensates the other party.

Exception

Some prepayment options could result in other party being forced to accept negative compensation – e.g. the lender receives an amount less than the unpaid amounts of principal and interest if the borrower chooses to prepay.

Earlier, these instruments being measured at FVTPL. However, now after amendment, such financial assets could be measured at amortised cost or at FVOCI if they meet the other relevant requirements of IFRS 9.

To be eligible for the exception, the fair value of the prepayment feature would have to be insignificant on initial recognition of the asset. If this is impracticable to assess based on the facts and circumstances that existed on initial recognition of the asset, then the exception would not be available. Also financial assets prepayable at current fair value would be measured at FVTPL. The same would apply if the prepayment amount includes the fair value cost to terminate a hedging instrument if the amount is inconsistent with the current IFRS 9 prepayment rules.

(c) a contractual term that permits the issuer or the holder to extend the contractual term of a debt instrument (ie an extension option) and the terms of the extension option result in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the extension of the contract.

Illustration 7

Instrument A is a bond with a stated maturity date. Payments of principal and interest on the principal amount outstanding are linked to an inflation index of the currency in which the instrument is issued. The inflation link is not leveraged and the principal is protected.

Evaluate the Contractual cash flows characteristics test

Solution

The contractual cash flows are solely payments of principal and interest on the principal amount outstanding. Linking payments of principal and interest on the principal amount outstanding to an unleveraged inflation index resets the time value of money to a current level. In other words, the interest rate on the instrument reflects 'real' interest. Thus, the interest amounts are consideration for the time value of money on the principal amount outstanding.

However, if the interest payments were indexed to another variable such as the debtor's performance (eg the debtor's net income) or an equity index, the contractual cash flows are not payments of principal and interest on the principal amount outstanding (unless the indexing to the debtor's performance results in an adjustment that only compensates the holder for changes in the credit risk of the instrument, such that contractual cash flows are solely payments of principal and interest). That is because the contractual cash flows reflect a return that is inconsistent with a basic lending arrangement.

*****

Illustration 8

Instrument F is a bond that is convertible into a fixed number of equity instruments of the issuer. Analyse the nature of cash flows.

Solution

The holder would analyse the convertible bond in its entirety. The contractual cash flows are not payments of principal and interest on the principal amount outstanding because they reflect a return that is inconsistent with a basic lending arrangement; ie the return is linked to the value of the equity of the issuer.

*****

Illustration 9

Instrument H is a perpetual instrument but the issuer may call the instrument at any point and pay the holder the par amount plus accrued interest due.

Instrument H pays a market interest rate but payment of interest cannot be made unless the issuer is able to remain solvent immediately afterwards. Deferred interest does not accrue additional interest. Analyse the nature of cash flows.

Solution

The contractual cash flows are not payments of principal and interest on the principal amount outstanding. That is because the issuer may be required to defer interest payments and additional interest does not accrue on those deferred interest amounts. As a result, interest amounts are not consideration for the time value of money on the principal amount outstanding.

If interest accrued on the deferred amounts, the contractual cash flows could be payments of principal and interest on the principal amount outstanding.

*****

Illustration 10

Instrument D is loan with recourse and is secured by collateral. Does the collateral affect the nature of contractual cash flows?

Solution

The fact that a loan is collateralised (since with recourse) does not in itself affect the analysis of whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding. The collateral is only a security to recover dues.

*****

Illustration 11

Instrument G is a loan that pays an inverse floating interest rate (ie the interest rate has an inverse relationship to market interest rates). Analyse the nature of cash flows.

Solution

Here, interest on the instrument has an inverse relationship to the market rate of interest. Hence, it is unlike a basic lending arrangement which normally comprises of interest payable on any funds lent, as a consideration for the time value of money, credit risk and profit margin normally existing in such arrangements. This arrangement with an inverse floating interest rate provides the lender with a return which may be higher or lower to the market rate of interest and hence, is not necessarily a consideration for the time value of money on the principal amount outstanding.

Thus, these do not represent contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

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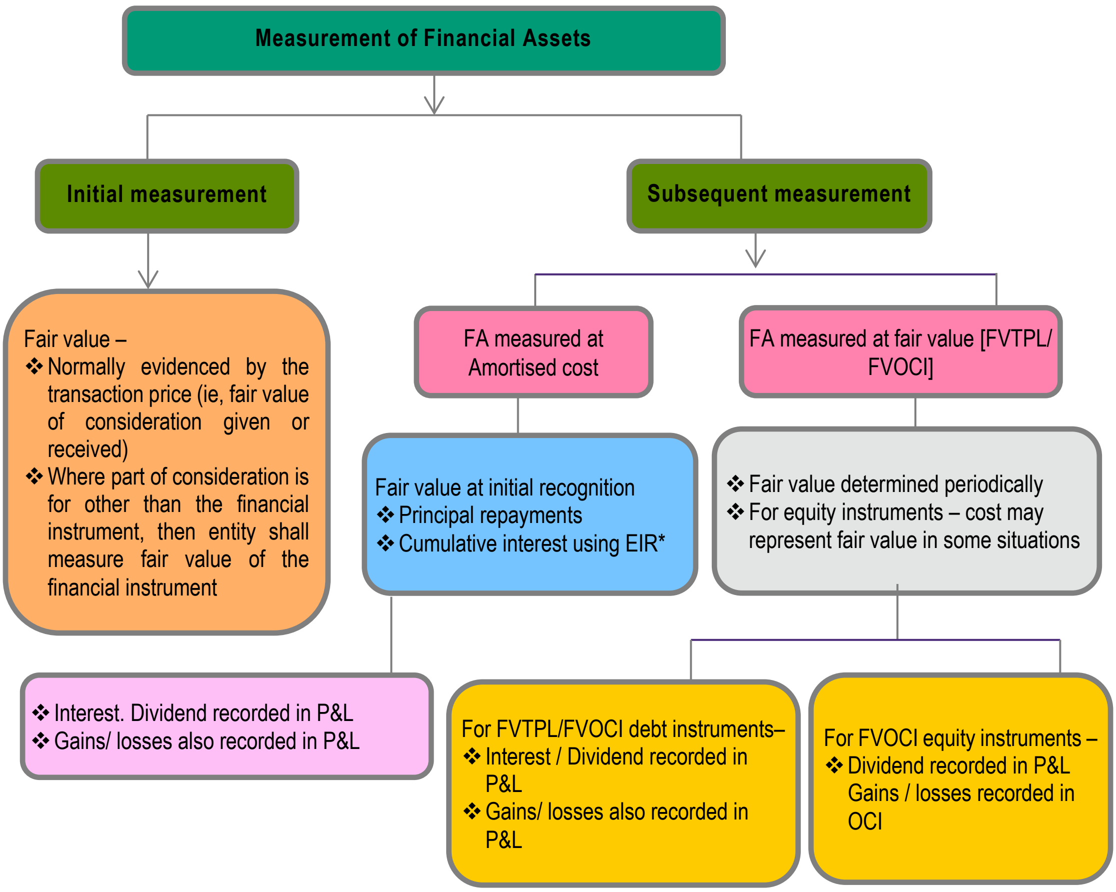
3.4 FINANCIAL ASSETS: MEASUREMENT

Measurement of financial assets is driven by their classification and can be broadly explained with the help of following diagrammatic presentation:



*EIR – Effective interest rate method

Before discussing the detailed aspects of initial and subsequent measurement, let's understand the meaning of the basic classification terms:

(A) Amortised cost

(B) Fair value

- **Amortised cost**

    - ♦ **Amortised cost** is the amount at which the financial asset is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.

    - ♦ **In applying effective interest method –**

        (a) Entity identifies fees that are an integral part of the effective interest rate of a financial instrument. Fees that are an integral part of the effective interest rate of a financial instrument are treated as an adjustment to the effective interest rate, unless the financial instrument is measured at fair value, with the change in fair value being recognised in profit or loss. In those cases, the fees are recognised as revenue or expense when the instrument is initially recognised.

        (b) Such fees adjusted in effective interest rate are then amortised over then expected life of the instrument. However, a shorter period may be used if such fee adjusted in effective interest rate pertains to such shorter period.

Fees that are integral part of effective interest rate	Fees that are not an integral part of effective interest rate
(a) **Origination fee** received by the entity relating to the creation or acquisition of a financial asset. Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument.	(a) **Fee** charged for **servicing a loan**;
(b) **Commitment fee** received by the entity **to originate a loan where it is probable that the entity will enter into a specific lending arrangement.** These	(b) **Commitment fee** to originate a loan when it is **unlikely that a specific lending arrangement will be entered into**;

fees are regarded as compensation for an ongoing involvement with the acquisition of a financial instrument. If the commitment expires without the entity making the loan, the fee is recognised as revenue on expiry.	
(c) **Origination fee** paid on issuing financial asset measured at amortised cost. These fees are an integral part of generating an involvement with a financial liability. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services.	(c) **Loan syndication fee** received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants).

Illustration 11

ABC Bank gave loans to a customer – Target Ltd. that carry fixed interest rate @ 10% per annum for a 5 year term and 12% per annum for a 3 year term. Additionally, the bank charges processing fees @1% of the principal amount borrowed. Target Ltd borrowed loans as follows:

- *₹ 10 lacs for a term of 5 years*
- *₹ 8 lacs for a term of 3 years.*

Compute the fair value upon initial recognition of the loan in books of Target Ltd. and how will loan processing fee be accounted?

Solution

The loans from ABC Bank carry interest @ 10% and 12% for 5 year term and 3 year term respectively. Additionally, there is a processing fee payable @ 1% on the principal amount on date of transaction. It is assumed that ABC Bank charges all customers in a similar manner and hence, this is representative of the market rate of interest.

Amortised cost is computed by discounting all future cash flows at market rate of interest. Further, any transaction fees that are an integral part of the transaction are adjusted in the effective interest rate and recognised over the term of the instrument.

Hence, loan processing fees shall be reduced from the principal amount to arrive the value on day 1 upon initial recognition.

Fair value (5 year term loan) = 10,00,000 – 10,000 (1%*10,00,000) = 9,90,000

Fair value (3 year term loan) = 8,00,000 – 8,000 (1%*8,00,000) = 7,92,000.

Now, effective interest rate shall be higher than the interest rate of 10% and 12% on 5 year loan and 3 year loan respectively, so that the processing fees gets recognised as interest over the respective term of loans.

*****

- **Fair value**

  Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

  Per Ind AS 113.B2 – The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions. A fair value measurement requires an entity to determine all the following:

  (a) the particular asset or liability that is the subject of the measurement (consistently with its unit of account);

  (b) for a non-financial asset, the valuation premise that is appropriate for the measurement (consistently with its highest and best use);

  (c) the principal (or most advantageous) market for the asset or liability.

  (d) the valuation technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use when pricing the asset or liability and the level of the fair value hierarchy within which the inputs are categorised.

  Now, we go on to understand the key aspects of initial and subsequent measurement along with how classification of assets affects their measurement as explained in detail below:

3.5 FINANCIAL ASSETS: INITIAL MEASUREMENT

Fair value of a financial instrument at initial recognition is **normally the transaction price** (,ie, fair value of consideration given or received).

- **Instrument at off-market terms:** Sometimes certain type of instruments may be exchanged at off market terms (,ie, different from market terms for a similar instrument if exchanged between market participants),

  - For example, 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. In such cases where part of the consideration given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument.

- In the aforementioned example, the fair value of the long-term loan or receivable can be measured as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. The additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.

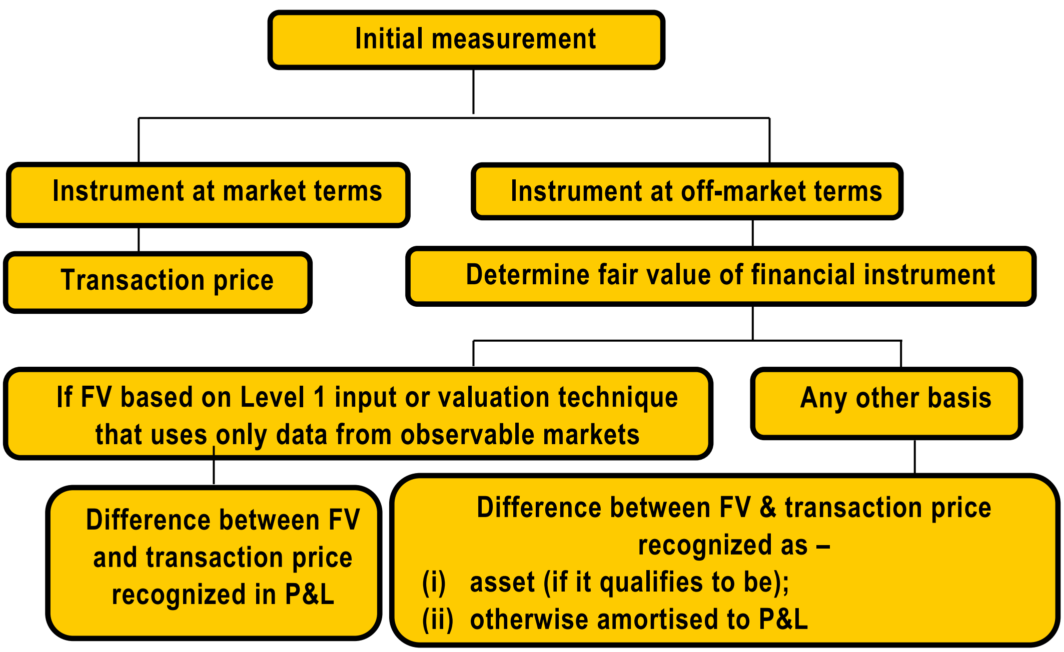
- **Transaction costs:**

  - Transaction costs include fees and commission paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and security exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

  - Any transaction costs incurred for acquisition of the financial asset are adjusted upon initial recognition while determining fair value.

  - If an entity originates a loan that bears an off-market interest rate (eg 5 per cent when the market rate for similar loans is 8 per cent), and receives an upfront fee as compensation, the entity recognises the loan at its fair value, ie net of the fee it receives.

The decision tree for the aforementioned basis to be applied in establishing fair value at initial recognition can be understood with following diagrammatic presentation:



- **Specific transactions:**

  - **Determining amortised cost for financial assets carrying floating rate of interest:**

    Per Application Guidance in Appendix B – B.5.4.5 – For floating rate financial instruments, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. To calculate the effective interest in each relevant period, the effective interest rate is applied to the amortised cost of the asset or liability at the previous reporting date. However, if the floating rate financial asset or financial liability is initially recognised at an amount equal to the principal receivable or payable on maturity, then this periodic re-estimation does not have a significant effect on the carrying amount of the asset or liability.

    Therefore, in such cases, for practical reasons the carrying amount of a floating rate instrument would not generally need to be adjusted at each repricing date because the impact would not generally be significant. In such case –

    (a) Interest income or expense is recognised based on the current market rate.

    (b) For a floating rate financial asset or financial liability that is initially recognised at a discount or premium, the interest income or expense is recognised based on the current market rate plus or minus amortisation or accretion of the discount or premium.

  - **Modification in cash flows:**

    Per Application Guidance in Appendix B to Ind AS 109 – B.5.4.6 – If there is a change in the timing or amount of estimated future cash flows (other than due to impairment) –

    - It shall adjust the gross carrying amount of the financial asset or amortised cost of a financial liability (or group of financial instruments) to reflect actual and revised estimated contractual cash flows.

    - The entity recalculates the gross carrying amount of the financial asset or amortised cost of the financial liability as the present value of the estimated future contractual cash flows that are discounted at the financial instrument's **original effective interest rate** (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets)

    Then the carrying amount of the instrument (or group of financial instruments) is adjusted in the period of change to reflect the actual and/or revised estimated cash flows, with a corresponding gain or loss being recognised in profit or loss.

    This approach to changes in estimated cash flows should apply to changing prepayment expectations and other estimates of cash flows under the current terms of the financial instrument but not to a renegotiation of the contractual terms of an instrument.

  - **Interest income after impairment recognition**

    If a financial asset or a group of similar financial assets has been written down as a result of an impairment loss –

- Then interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.
- For assets measured at amortised cost, this interest rate would be the original effective interest rate.

♦ **Loans between group companies**

(a) Repayable on demand:

As per Ind AS 113.47 – The fair value of a financial liability with a demand feature - e.g. a demand deposit - is not less than the amount payable on demand, discounted from the first date that the entity could be required to repay the amount. Accordingly –

- The fair value of an interest-free loan liability of which the lender can demand repayment of the face value at any time - i.e. a loan repayable on demand - is not less than its face value.
- This would evenly apply from the perspective of the lender, since a market participant acting in its best interest would be assumed to maximize value by demanding immediate repayment and hence, the fair value shall be equal to the amount payable on demand in books of lender.

(b) No fixed maturity:

If a loan has no fixed maturity date and is available in perpetuity, then in measuring its fair value, discounting should reflect these terms because a market participant acting in its best interest would not assume repayment of the loan. Similarly, the asset holder or lender would also measure fair value that should reflect a market participant's assumptions about the timing of the future cash flows.

In both of above cases–

- Any difference between the amount lent and the fair value of the instrument on initial recognition is recognized as a gain or a loss unless it qualifies for recognition as an asset or a liability.
- If a low-interest loan is given in anticipation of a right to receive goods or services at favorable prices, then the right may be recognised as an asset if it qualifies for recognition as an asset, for example: prepaid expenses, etc.

♦ **Demand deposits**

The fair value of a financial liability with a demand feature - e.g. a demand deposit - is not less than the amount payable on demand, discounted from the first date that the entity could be required to repay the amount.

Hence, fair value of a demand deposit would be the amount payable on demand in books of the party making the deposit (ie, holder of financial asset) as well as in books of entity accepting the deposit (ie, bearer of financial liability).

Illustration 12: Deposits carrying off-market rate of interest:

Containers Ltd provides containers for use by customers for multiple purposes. The containers are returnable at the end of the service contract period (3 years) between Containers Ltd and its customers. In addition to the monthly charge, there is a security deposit that each customer makes with Containers Ltd for ₹ 10,000 per container and such deposit is refundable when the service contract terminates. Deposits do not carry any interest. Analyse the fair value upon initial recognition in books of customers leasing containers. Market rate of interest for 3 year loan is 7% per annum.

Solution

In the above case, lessee (ie, customers leasing the containers) make interest free deposits, which are refundable at the end of 3 years. Now, this money if it was to lent to a third party would fetch interest @ 7% per annum.

Hence, discounting all future cash flows (ie, ₹ 10,000)

Fair value on initial recognition = $10,000/ (1+0.07)^3$ = 8,163.

Differential on day 1 = 10,000 – 8,163 = 1,837

The differential on day 1 shall be treated as follows:

- **Scenario 1 –** If fair valuation is determined using level 1 inputs or other observable inputs, difference on day 1 recognised in profit or loss
- **Scenario 2 –** If fair valuation is determined using other inputs, difference on day 1 shall be recognised in profit or loss unless it meets definition of an asset or liability.

In the above case, the fair valuation is made based on unobservable inputs and hence applying scenario 2, difference can be recognised as an asset if it meets the definition. Now, since the lessee gets to use the containers in return for making an interest free deposit plus monthly charges, the lost interest representing day 1 difference between value of deposit and its fair value is like ''prepaid lease rent' and can be recognised as such. Prepaid rent shall be charged off to profit or loss in a straight lined manner as 'lease rent'.

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3.6 FINANCIAL ASSETS: SUBSEQUENT MEASUREMENT

- As defined in the flow chart above, the subsequent measurement of financial assets is based on their classification as defined below:

  (A) Assets measured at amortised cost

  ♦ Assets are classified as measured at amortised cost if below conditions are met (as explained in paragraph – Financial assets: classification):

  (a) Financial asset is held with BM whose objective is to hold financial assets in order to collect contractual cash flows; and

(b) Contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding

- Where assets are classified as 'amortised cost' –
  - They are initially measured at fair value as explained above
  - Subsequently, the carrying value is adjusted for principal repayments and interest accrued using effective interest rate, as explained earlier.

(B) Assets measured at fair value

- For assets not carried at amortised cost, they shall be carried at fair value. Such assets can be categorised into –

  i. **Measured at fair value through other comprehensive income (FVOCI)**; if –

  (a) Following criteria are satisfied:
  - FA is held with BM whose objective is achieved both by collecting contractual cash flows and selling FA; and
  - Contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding

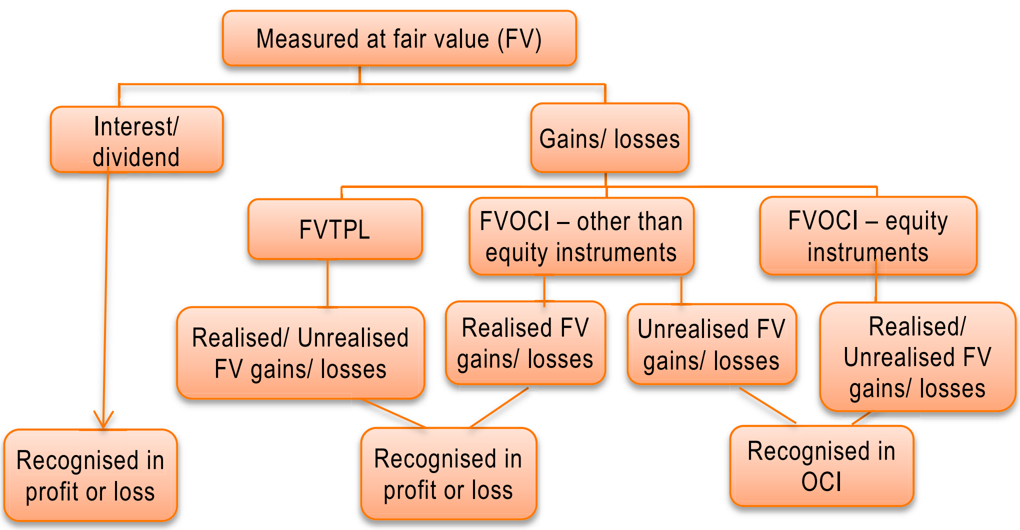
Or

  (b) An equity instrument, which otherwise shall be carried at fair value through profit or loss may be irrevocably recognised at fair value through other comprehensive income,

  ii. Measured at fair value through profit or loss (FVTPL):

  All assets not classified as 'measured at amortised cost' or 'measured at fair value through OCI' shall be classified in this category.

Incomes and/ or expenses on assets measured at fair value shall be recognised as follows:



- If a financial instrument that was previously recognised as a financial asset is measured at fair value through profit or loss and its fair value decreases below zero, it is a financial liability measured at fair value.
- **Equity instruments – where FV not determinable**
  - ♦ All investments in equity instruments and contracts on those instruments must be measured at fair value. However, in limited circumstances, cost may be an appropriate estimate of fair value. That may be the case if insufficient more recent information is available to measure fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range
  - ♦ **Indicators that cost might not be representative of fair value include:**

    (a) a significant change in the performance of the investee compared with budgets, plans or milestones.

    (b) changes in expectation that the investee's technical product milestones will be achieved.

    (c) a significant change in the market for the investee's equity or its products or potential products.

    (d) a significant change in the global economy or the economic environment in which the investee operates.

    (e) a significant change in the performance of comparable entities, or in the valuations implied by the overall market.

    (f) internal matters of the investee such as fraud, commercial disputes, litigation, changes in management or strategy.

    (g) evidence from external transactions in the investee's equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties.
  - ♦ The list above is not exhaustive. An entity shall use all information about the performance and operations of the investee that becomes available after the date of initial recognition. To the extent that any such relevant factors exist, they may indicate that cost might not be representative of fair value. In such cases, the entity must measure fair value.
  - ♦ Cost is never the best estimate of fair value for investments in quoted equity instruments (or contracts on quoted equity instruments).

Illustration 13: Accounting for transaction costs on initial and subsequent measurement of a financial asset measured at fair value with changes through other comprehensive income:

An entity acquires a financial asset for CU100 plus a purchase commission of CU2. Initially, the entity recognises the asset at CU102. The reporting period ends one day later, when the *quoted market price of the asset is CU100. If the asset were sold, a commission of CU3 would be paid. How would transaction costs be accounted in books of the entity?*

Solution

- On that date, the entity measures the asset at CU100 (without regard to the possible commission on sale) and recognises a loss of CU2 in other comprehensive income.
- If the financial asset is measured at fair value through other comprehensive income in accordance with Ind AS 109.4.1.2A, the transaction costs are amortised to profit or loss using the effective interest method.

*****

Illustration 14: Determining fair value upon initial measurement

The shareholders of Company C provide C with financing in the form of loan notes to enable it to acquire investments in subsidiaries. The loan notes will be redeemed solely out of dividends received from these subsidiaries and become redeemable only when C has sufficient funds to do so. In this context, 'sufficient funds' refers only to dividend receipts from subsidiaries. Analyse the initial measurement of loan notes.

Solution

In this case –

Loan notes are repayable only then C earns returns in form of dividends from subsidiaries. Hence, C cannot be forced to obtain additional external financing or to liquidate its investments to redeem the shareholder loans. Consequently, the loan notes are not considered payable on demand.

Accordingly –

- Loan notes shall be initially measured at their fair value (plus transaction costs), being the present value of the expected future cash flows, discounted using a market-related rate. The amount and timing of the expected future cash flows should be determined on the basis of the expected dividend flow from the subsidiaries. Also, the valuation would need to take into account possible early repayments of principal and corresponding reductions in interest expense.
- Since the loan notes are interest-free or bear lower-than-market interest, there will be a difference between the nominal value of the loan notes - i.e. the amount granted - and their fair value on initial recognition. Because the financing is provided by shareholders, acting in the capacity of shareholders, the resulting credit should be reflected in equity as a shareholder contribution in C's balance sheet. Conversely, in books of shareholders, the difference between amount invested and its fair value shall be recorded as ‘investment in C Ltd’ being representative of the underlying relationship between shareholders and C Ltd.

*****

Illustration 15 : Use of cost v/s fair value determination for equity instruments

Silver Ltd. has made an investment in optionally convertible preference shares (OCPS) of a Company – Bronze Ltd. at ₹ 100 per share (face value ₹ 100 per share). Silver Ltd. has an option to convert these OCPS into equity shares in the ratio of 1:1 and if such option not exercised till end of 9 years, then the shares shall be redeemable at the end of 10 years at a premium of 20%.

Analyse the measurement of this investment in books of Silver Ltd.

Solution

The classification assessment for a financial asset is done based on two characteristics:

i. Whether the contractual cash flows comprise cash flows that are solely payments of principal and interest on the principal outstanding

ii. Entity's business model (BM) for managing financial assets – Whether the Company's BM is to collect cash flows; or a BM that involves realisation of both contractual cash flows & sale of financial assets;

In all other cases, the financial assets are measured at fair value through profit or loss.

In the above case, the Holder can realise return either through conversion or redemption at the end of 10 years, hence it does not indicate contractual cash flows that are solely payments of principal and interest. Therefore, such investment shall be carried at fair value through profit or loss. Accordingly, the investment shall be measured at fair value periodically with gain/ loss recorded in profit or loss.

*****

Illustration 16 : Accounting for assets at amortised cost

A Ltd has made a security deposit whose details are described below. Make necessary journal entries for accounting of the deposit. Assume market interest rate for a deposit for similar period to be 12% per annum.

Particulars	*Details*
Date of Security Deposit (Starting Date)	*1-Apr-20X1*
Date of Security Deposit (Finishing Date)	*31-Mar-20X6*
Description	*Lease*
Total Lease Period	*5 years*
Discount rate	*12.00%*
Security deposit (A)	*10,00,000*
Present value factor at the 5^{th} year	*0.567427*

Solution

The above security deposit is an interest free deposit redeemable at the end of lease term for ₹ 10,00,000. Hence, this involves collection of contractual cash flows and shall be accounted at amortised cost.

Upon initial measurement –

Particulars	Details
Security deposit (A)	10,00,000
Total Lease Period (Years)	5
Discount rate	12.00%
Present value annuity factor	0.56743
Present value of deposit at beginning (B)	5,67,427
Prepaid lease payment at beginning (A-B)	4,32,573

Journal Entries

Particulars		Amount	Amount
Security deposit a/c	Dr.	5,67,427	
Prepaid expenses	Dr.	4,32,573	
To Bank a/c			10,00,000

Subsequently, every annual reporting year, interest income shall be accrued@ 12% per annum and prepaid expenses shall be amortised on straight line basis over the lease term.

For instance – year 1

Particulars		Amount	Amount
Security deposit a/c (5,67,427 x 12%)	Dr.	68,091	
To Interest income			68,091
Rent expense (4,32,573 / 5 years)	Dr.	86,515	
To Prepaid expenses			86,515

At the end of 5 years, the security deposit shall accrue to ₹ 10,00,000 and prepaid expenses shall be fully amortised. Journal entry for realisation of security deposit –

Particulars		Amount	Amount
Bank a/c	Dr.	10,00,000	
To Security deposit a/c			10,00,000

*****

Illustration 17 : Accounting for assets at FVTPL

A Ltd. invested in equity shares of C Ltd. on 15th March for ₹ 10,000. Transaction costs were ₹ 500 in addition to the basic cost of ₹ 10,000. On 31 March, the fair value of the equity shares was ₹ 11,200 and market rate of interest is 10% per annum for a 10 year loan. Pass necessary journal entries. Analyse the measurement principle and pass necessary journal entries.

Solution

The above investment is in equity shares of C Ltd and hence, does not involve any contractual cash flows that are solely payments of principal and interest. Hence, these equity shares shall be measured at fair value through profit or loss. Also, an irrecoverable option exists to designate such investment as fair value through other comprehensive income.

Journal Entries

Particulars	Amount	Amount
Upon initial recognition –		
Investment in equity shares of C Ltd. Dr.	10,000	
Transaction cost Dr.	500	
To Bank A/c		10,500
(Being investment recognized at fair value plus transaction costs upon initial recognition)		
Profit and Loss A/c Dr.	500	
To Transaction cost		500
(Being transaction cost incurred on assets measured at FVTPL transferred to P&L A/c)		

Subsequently –		
Investment in equity shares of C Ltd. Dr.	1,200	
To Fair value gain on financial instruments		1,200
(Being fair value gain recognized at year end in P&L)		
Fair value gain on financial instruments Dr.	1,200	
To Profit and Loss A/c		1,200
(Being fair value gain transferred to P&L A/c)		

*****

Illustration 18: Accounting for assets at FVOCI

Metallics Ltd. has made an investment in equity instrument of a company – Castor Ltd. for 19% equity stake. Significant influence not exercised. The investment was made for ₹ 5,00,000 for 10,000 equity shares on 01 April 20X1. On 30 June 20X1 the fair value per equity share is ₹45. The Company has taken an irrevocable option to measure such investment at fair value through other comprehensive income.

Solution

The Company has made an irrecoverable option to carry its investment at fair value through other comprehensive income. Accordingly, the investment shall be initially recognised at fair value and all subsequent fair value gains/ losses shall be recognised in other comprehensive income (OCI).

Journal Entries

Particulars	Amount	Amount
Upon initial recognition –		
Investment in equity shares of C Ltd. Dr.	5,00,000	
To Bank a/c		5,00,000
(Being investment recognized at fair value plus transaction costs upon initial recognition)		
Subsequently –		
Fair value loss on financial instruments Dr.	50,000	
To Investment in equity shares of C Ltd.		50,000
(Being fair value loss recognised)		
Fair value reserve in OCI Dr.	50,000	
To Fair value loss on financial instruments		50,000
(Being fair value loss recognized in other comprehensive income)		

*****

3.7 FINANCIAL LIABILITIES: CLASSIFICATION

- Upon initial recognition, all financial liabilities are measured at fair value. Subsequently, per Ind AS 109.4.2.1 – the classification of financial liabilities shall be as follows:

  (A) Measured at amortised cost

  (B) Measured at fair value through profit or loss:

- ♦ Liabilities that meet the definition of "held for trading"
- ♦ Contingent consideration recognized by an acquirer in a business combination

(C) Designated at fair value through profit or loss

(D) Other specific measurement basis (with changes recognized in profit or loss):

- ♦ financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies: refer paragraph 3.2.15 or 3.2.17 of Ind AS 109
- ♦ financial guarantee contracts and commitments to provide a loan at a below-market interest rate are subsequently measured at higher of:
  - ▪ the amount of the loss allowance, and
  - ▪ the amount initially recognised (see paragraph 5.1.1) less, when appropriate, the cumulative amount of income recognised in accordance with the principles of Ind AS 115."

Irrespective of above classification, any financial liabilities may be designated at fair value through profit or loss if:

i. It eliminates or significantly reduces a measurement or recognition inconsistency (**'accounting mismatch'**) that would otherwise arise from measuring assets or liabilities; or their gains on a different basis; or

ii. A group of financial liabilities and financial assets is managed and its performance is evaluated on fair value basis, in accordance with a documented risk management or investment strategy, and information about that group is provided internally on that basis to the entity's key management personnel.

- **Financial assets and financial liabilities held for trading:**
  - ♦ Financial assets and liabilities held for trading are defined as those that:

    (a) are acquired or incurred principally for the purpose of sale or repurchase in the near term;

    (b) on initial recognition are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or

    (c) are derivatives (except for those that are financial guarantee contracts or are designated effective hedging instruments).

    Trading generally reflects active and frequent buying and selling, and financial instruments held for trading are normally used with the objective of generating a profit from short-term fluctuations in price or a dealer's margin.
  - ♦ In addition to derivatives that are not accounted for as hedging instruments, financial liabilities held for trading include:

(a) obligations to deliver financial assets borrowed by a short seller (i.e. an entity that sells financial assets it has borrowed and does not yet own);

(b) financial liabilities that are incurred with an intention to repurchase them in the near term, such as quoted debt instruments that the issuer may buy back in the near term depending on changes in fair value; and

(c) financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking.

However, the fact that a liability is used merely to fund trading activities does not in itself make that liability one that is held for trading.

Illustration 19 : Trade creditors at market terms

A Company purchases its raw materials from a vendor at a fixed price of ₹ 1,000 per tonne of steel. The payment terms provide for 45 days of credit period, after which an interest of 18% per annum shall be charged. How would the creditors be classified in books of the Company?

Solution

In the above case, creditors for purchase of steel shall be carried at amortised cost, ie, fair value of amount payable upon initial recognition plus interest (if payment is delayed). Here, fair value upon initial recognition shall be the price per tonne, since the transaction is at market terms between two knowledgeable parties in an arms-length transaction and hence, the transaction price is representative of fair value.

*****

Illustration 20

Silver Ltd. has purchased 100 ounces of gold on 10 March 20X1. The transaction provides for a price payable which is equal to market value of 100 ounces of gold on 10 April 20X1 and shall be settled by issue of such number of equity shares as is required to settle the aforementioned transaction price at ₹ 10 per share on 10 April 20X1. Whether this is classified as liability or equity? Own use exemption does not apply.

Solution

In the above scenario, there is a contract for purchase of 100 ounces of gold whose consideration varies in response to changing value of gold. Analysing this contract as a derivative –

(a) Value of contract changes in response to change in market value of gold;

(b) There is no initial net investment

(c) It will be settled at a future date, i.e. 10 April 20X1.

Since the above criteria are met, this is a derivative contract.

Now, a derivative contract that is settled in own equity other than exchange of fixed amount of cash for fixed number of shares is classified as 'liability'. In this case, since the contract results in issue of variable number of shares based on transaction price to be determined in future, hence, this shall be classified as 'derivative financial liability'.

Per Ind AS 109.4.2.1 – A derivative financial liability shall be carried at fair value through profit or loss.

*****

Illustration 21

*An entity is about to purchase a portfolio of **fixed rate assets** that will be **financed by fixed rate debentures**. Both financial assets and financial liabilities are subject to the same interest rate risk that gives rise to opposite changes in fair value that tend to offset each other. Provide your comments.*

Solution

The fixed rate assets provide for contractual cash flows and based on business model of the entity, such fixed rate assets may be classified as 'amortised cost' (if entity collects contractual cash flows) or fair value through other comprehensive income (FVOCI) (if entity manages through collecting contractual cash and sale of financial assets).

In the absence of fair value option, the entity can classify the fixed rate assets as FVOCI with gains and losses on changes in fair value recognised in other comprehensive income and fixed rate debentures at amortised cost. However, reporting both assets and liabilities at fair value through profit and loss, ie, FVTPL corrects the measurement inconsistency and produces more relevant information.

Hence, it may be appropriate to classify the entire group of fixed rate assets and fixed rate debentures at fair value through profit or loss (FVTPL).

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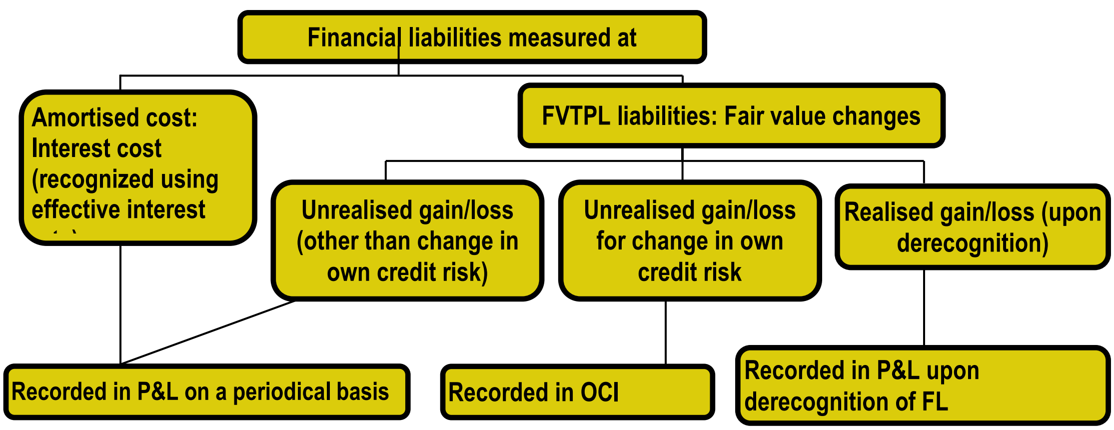
3.8 FINANCIAL LIABILITIES: MEASUREMENT

- Measurement of financial liabilities is driven by their classification upon initial recognition as follows:



- **Specific transactions – restructuring of financial liability**

  If the terms of a financial liability are modified substantially, resulting in an extinguishment of the old financial liability, then the old liability is derecognised and the restructured financial instrument is treated as a new financial liability. If a modification of a financial liability results in derecognition of the financial liability, then the effective interest rate of the new financial liability is calculated based on the revised terms of the financial liability at the date of the modification. In this case, any costs or fees incurred are recognised as part of the gain or loss on extinguishment and do not adjust the carrying amount of the new liability.

  If the exchange or modification is not accounted for as an extinguishment, then any costs and fees incurred are recognised as an adjustment to the carrying amount of the liability. For changes in future cash flows, the entity shall revised the amortised cost of the financial liability to reflect revised future cash flows by discounting them to their present value at the original effective interest rate. The difference between the carrying value and revised amortised cost is recognized as a gain or loss in profit or loss.

Illustration 22: Issue of borrowings with fixed rate of interest

A Ltd has made a borrowing from RBC Bank for ₹ 10,000 at a fixed interest of 12% per annum. Loan processing fees were additionally paid for ₹ 500 and loan is payable 4 half-yearly installments of ₹ 2,500 each. Details are as follows:

Particulars	*Details*
Loan amount	*₹ 10,000*
Date of loan (Starting Date)	*1-Apr-20X1*
Date of loan (Finishing Date)	*31-March-20X3*
Description of repayment	*Repayment of loan starts from 30-Sept-20X1 (To be paid half yearly)*
Installment amount	*₹ 2,500*
Interest rate	*12.00%*
Interest charge	*Interest to be charged quarterly*
Upfront fees	*₹ 500*

How would loan be accounted in books of A Ltd?

Solution

The loan taken by A Ltd shall be measured at amortised cost as follows:

- Initial measurement – At transaction price less processing fees

  = 10,000 – 500 = 9,500

- Subsequently – interest to be accrued using effective rate of interest as follows:

Date	Amount of Loan	Re-payment	Upfront fees paid	Amount of Interest	Days	IRR Calcula-tion	Revised Interest computed	Loan Balance
1-Apr-20X1	10,000	-	500	-	-	9,500	-	-
30-Jun-20X1	-	-	-	300	90	(300)	389	9,589
30-Sep-20X1	-	2500	-	300	92	(2,800)	401	7,190
31-Dec-20X1	-	-	-	225	92	(225)	301	7,266
31-Mar 20X2	-	2500	-	225	90	(2,725)	297	4,838
30-Jun-20X2	-	-	-	150	91	(150)	200	4,888
30-Sep-20X2	-	2500	-	150	92	(2,650)	204	2,442
31-Dec-20X2	-	-	-	75	92	(75)	102	2,473
31-Mar-20X3	-	2500	-	75	91	(2,575)	102	0
					IRR	**16.60%**		

*****

Illustration 23 : Issue of variable number of shares against issue of CCPS

A Ltd. issued compulsorily convertible preference shares (CCPS) at ₹ 100 each (₹ 10 face value + ₹ 90 premium per share) for ₹ 10,00,000. These are convertible into equity shares at the end of 10 years, where the number of equity shares to be issued shall be determined based on fair value per equity share to be determined at the time of conversion.

Evaluate if this is financial liability or equity? What if the conversion ratio was fixed at the time of issue of such preference shares?

Solution

i. As per Ind AS 109, non-derivative contracts which will be settled against issue of variable number of own equity shares meet the definition of financial liability.

In this case, A Ltd. has issued CCPS which are convertible into variable number of shares. Hence, it is akin to use of own equity shares as currency for settlement of the liability of CCPS issued. Accordingly, it meets the definition of financial liability.

Measurement –

Initial measurement – This shall be measured at fair value on date of transaction. Since A Ltd shall give shares worth ₹ 10 lacs at the end of 10 years which is equal to the amount borrowed on day 1, the liability is recognised at fair value, determined by discounting future settlement of the borrowed amount. For difference arising on day 1 between amount borrowed and that recognised as liability using level 3 inputs, it is deferred and recognised on a systematic basis over the period of liability.

Subsequent measurement – Such liability shall be carried at fair value through profit or loss.

ii. Per Ind AS 109, a non-derivative contract that involves issue of fixed number of equity shares shall be classified as equity.

In this case, if the conversion of CCPS was into a fixed number of equity shares at the end of 10 years, then it meets the definition of equity and hence, shall be classified as 'equity instrument'.

An equity instrument is carried at cost and no further adjustments made to its carrying value after initial recognition.

*****

3.9 RECLASSIFICATION OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Per Ind AS 109.4.4.1 – An entity shall reclassify financial assets, *only* if the entity changes its business model for managing those financial assets.

- **Such changes are expected to be very infrequent.** Such changes are determined by the entity's senior management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties. Accordingly, a change in an entity's business model will occur only when an entity either begins or ceases to perform an activity that is significant to its operations; for example, when the entity has acquired, disposed of or terminated a business line.
- **Examples** of a change in business model include the following:
  (a) An entity has a portfolio of commercial loans that it holds to sell in the short term. The entity acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows.
  (b) A financial services firm decides to shut down its retail mortgage business. That business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.
- **Accounting for reclassification of financial assets:**
  - ♦ A change in the objective of the entity's business model must be effected before the reclassification date. For example, if a financial services firm decides on 15 February to shut down its retail mortgage business and hence must reclassify all affected financial assets on 1 April (ie the first day of the entity's next reporting period), the entity must

not accept new retail mortgage business or otherwise engage in activities consistent with its former business model after 15 February.

- ♦ If an entity reclassifies any financial asset, it must do so **prospectively from reclassification date.**
- ♦ The entity shall **not restate** any previously recognised gains, losses (including impairment gains or losses) or interest.

- **Following are not changes in business model:**

  (a) a change in intention related to particular financial assets (even in circumstances of significant changes in market conditions);

  (b) the temporary disappearance of a particular market for financial assets;

  (c) a transfer of financial assets between parts of the entity with different business models.

- **Following changes in circumstances are not reclassifications:**

  (a) an item that was previously a designated and effective hedging instrument in a cash flow hedge or net investment hedge no longer qualifies as such;

  (b) an item becomes a designated and effective hedging instrument in a cash flow hedge or net investment hedge; and

  (c) changes in measurement for a financial instrument, if the entity takes credit derivative that is measured at fair value through profit or loss to manage the credit risk of all, or part of such financial instrument and consequently, the underlying financial instrument is also designated at fair value through profit or loss.

- **Financial liabilities are not permitted to be reclassified.**

  Illustrative examples:

  - ♦ **Case 1:** Amortised cost to FVTPL
    - It is measured at fair value on reclassification date.
    - Any gain or loss arising from difference between the previous amortised cost of the financial asset and fair value is recognised in profit or loss.

Illustration 24

Bonds for ₹ 1,00,000 reclassified as FVTPL. Fair value on reclassification is ₹ 90,000. Pass the required journal entry.

Solution

Particulars		Amount	Amount
Bonds at FVTPL	Dr.	90,000	

Loss on reclassification	Dr.	10,000	
To Bonds at amortised cost			1,00,000

- **Case 2:** Amortised cost to FVOCI
  - It is measured at fair value on reclassification date.
  - Any gain or loss arising from difference between the previous amortised cost of the financial asset and fair value is recognised in other comprehensive income
  - Effective interest rate and measurement of expected credit losses are not adjusted as a result of reclassification.

*****

Illustration 25

Bonds for ₹ 1,00,000 reclassified as FVOCI. Fair value on reclassification is ₹ 90,000. Pass the required journal entry.

Solution

Particulars		Amount	Amount
Bonds at FVOCI	Dr.	90,000	
OCI (Loss on reclassification)	Dr.	10,000	
To Bonds at amortised cost			1,00,000

*****

- **Case 3:** FVTPL to Amortised cost
  - It is measured at fair value on reclassification date and this fair value becomes the new gross carrying amount. Effective interest rate is computed based on this new gross carrying amount.
  - Any gain or loss arising from difference between the previous amortised cost of the financial asset and fair value is recognised in profit or loss.

Illustration 26

Bonds for ₹ 100,000 reclassified as Amortised cost. Fair value on reclassification is ₹ 90,000. Pass the required journal entry.

Solution

Particulars		Amount	Amount
Bonds at Amortised cost	Dr.	90,000	
Loss on reclassification	Dr.	10,000	
To Bonds at FVTPL			1,00,000

*****

- **Case 4:** FVTPL to FVOCI
  - The financial asset continues to be measured at fair value.
  - The effective interest rate is determined on the basis of fair value of asset at reclassification date.

Illustration 27

Bonds for ₹ 100,000 reclassified as FVOCI. Fair value on reclassification is ₹ 90,000. Pass the required journal entry.

Solution

Particulars		Amount	Amount
Bonds at FVOCI	Dr.	90,000	
Loss on reclassification	Dr.	10,000	
To Bonds at FVTPL			1,00,000

*****

- **Case 5:** FVOCI to Amortised cost
  - The financial asset is measured at fair value on reclassification date.
  - However, cumulative gain or loss previously recognised in other comprehensive income (OCI) is removed from equity and adjusted against fair value of financial asset at reclassification date.
  - As a result, the financial asset is measured at reclassification date as if it had always been measured at amortised cost. This adjustment affects OCI but does not affect profit or loss and therefore, is not a reclassification adjustment.
  - Effective interest rate and measurement of expected credit losses are not adjusted as a result of reclassification.

Illustration 28

Bonds for ₹ 100,000 reclassified as Amortised cost. Fair value on reclassification is ₹ 90,000 and ₹ 10,000 loss was recognised in OCI till date of reclassification. Pass required journal entry.

Solution

Particulars		Amount	Amount
Bonds at FVOCI	Dr.	10,000	
To OCI - Loss on reclassification			10,000
[Being loss recognized in OCI now reversed prior to reclassification]			

Bonds (Amortised cost)	Dr.	100,000	
To Bonds at FVOCI			100,000
[Being bonds reclassified from FVOCI to Amortised cost]			

*****

- **Case 6:** FVOCI to FVTPL
  - The financial asset continues to be measured at fair value.
  - The cumulative gain or loss previously recognised in other comprehensive income (OCI) is reclassified from equity to profit or loss as a reclassification adjustment at the reclassification date.

Illustration 29

Bonds for ₹ 100,000 reclassified as FVTPL. Fair value on reclassification is ₹ 90,000. Pass the required journal entry.

Solution

Particulars		Amount	Amount
P&L - Loss on reclassification	Dr.	10,000	
To OCI - Loss on reclassification			10,000
Bonds at FVTPL	Dr.	90,000	
To Bonds at FVOCI			90,000

*****

3.10 IMPAIRMENT

- **Scope of impairment**

An entity shall recognise a loss allowance for expected credit losses on the following:

(a) a financial asset that is measured at amortised cost

(b) a financial asset that is measured at fair value through other comprehensive income

(c) a lease receivable,

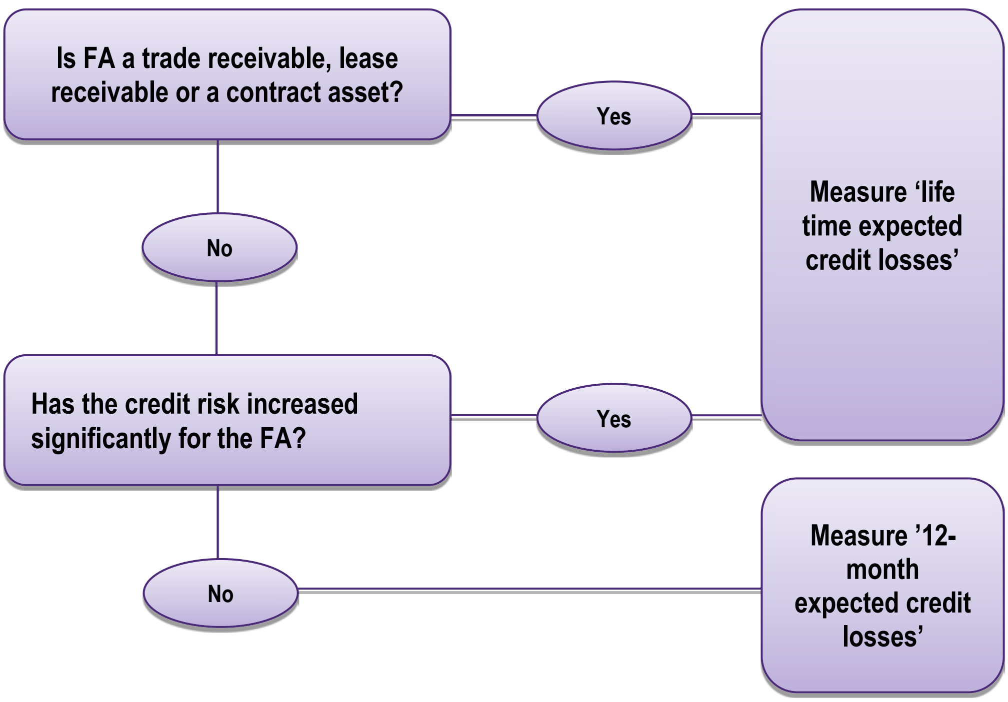
(d) a contract asset or a loan commitment; and

(e) a financial guarantee contract (covered within the scope of financial instruments, as referred in Unit 1 – Scope and Definitions)

- **What is a credit loss allowance?**
  - For financial assets, a credit loss is the present value of the difference between:
    (a) the contractual cash flows that are due to an entity under the contract; and
    (b) the cash flows that the entity expects to receive (,ie, cash short falls) discounted at original effective interest rate (or credit adjusted effective interest rate in case of purchased or originated credit-impaired financial assets).
  - An entity shall estimate cash flows by considering all contractual terms of the financial instrument (for eg.: prepayment, extension, call and similar options) through the expected life of the financial instrument.
  - The cash flows that are considered shall include cash flows from sale of collateral held or other credit enhancements that are integral to the contractual terms. There is a presumption that the expected life of the financial instrument can be estimated reliably. In those rare cases when it is no possible to reliably estimate the expected life of a financial instrument, the entity shall use the remaining contractual term of the financial instrument.

- **How is loss allowance to be provided?**

  The decision tree to be applied in determining whether the entity needs to provide for 12-month expected credit losses or life time expected credit losses is applied as follows:



- **Determining whether credit risk has increased significantly:**

  Ind AS 107 defines **credit risk** as 'the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation'.

  - ♦ When determining whether the recognition of lifetime expected credit losses is required, an entity shall consider reasonable and supportable information that is available without undue cost or effort and that may affect the credit risk on a financial instrument.

  - ♦ The following non-exhaustive list of information may be relevant in assessing changes in credit risk:

    (a) significant changes in internal price indicators of credit risk as a result of a change in credit risk since inception, including, but not limited to, the credit spread that would result if a particular financial instrument or similar financial instrument with the same terms and the same counterparty were newly originated or issued at the reporting date.

    (b) other changes in the rates or terms of an existing financial instrument that would be significantly different if the instrument was newly originated or issued at the reporting date (such as more stringent covenants, increased amounts of collateral or guarantees, or higher income coverage) because of changes in the credit risk of the financial instrument since initial recognition.

    (c) significant changes in external market indicators of credit risk for a particular financial instrument or similar financial instruments with the same expected life. Changes in market indicators of credit risk include, but are not limited to:

      i. the credit spread;

      ii. the credit default swap prices for the borrower;

      iii. the length of time or the extent to which the fair value of a financial asset has been less than its amortised cost; and

      iv. other market information related to the borrower, such as changes in the price of a borrower's debt and equity instruments.

    (d) an actual or expected significant change in the financial instrument's external credit rating.

    (e) an actual or expected internal credit rating downgrade for the borrower or decrease in behavioural scoring used to assess credit risk internally.

    (f) existing or forecast adverse changes in business, financial or economic conditions that are expected to cause a significant change in the borrower's ability to meet its debt obligations, such as an actual or expected increase in interest rates or an actual or expected significant increase in unemployment rates

    (g) an actual or expected significant change in the operating results of the borrower, for eg.: actual or expected declining revenues or margins, increasing operating risks, working capital deficiencies, decreasing asset quality, increased balance sheet leverage, liquidity, management problems or changes in the scope of business or organisational structure, etc. that results in a significant change in the borrower's ability to meet its debt obligations

(h) significant increases in credit risk on other financial instruments of the same borrower

(i) an actual or expected significant adverse change in the regulatory, economic, or technological environment of the borrower

(j) significant changes in the value of the collateral supporting the obligation or in the quality of third-party guarantees or credit enhancements;

(k) a significant change in the quality of the guarantee provided by a shareholder (or an individual's parents) if the shareholder (or parents) have an incentive and financial ability to prevent default by capital or cash infusion

(l) significant changes, such as reductions in financial support from a parent entity or other affiliate or an actual or expected significant change in the quality of credit enhancement, that are expected to reduce the borrower's economic incentive to make scheduled contractual payments

(m) expected changes in the loan documentation including an expected breach of contract that may lead to covenant waivers or amendments, interest payment holidays, interest rate step-ups, requiring additional collateral or guarantees, or other changes to the contractual framework of the instrument

(n) significant changes in the expected performance and behaviour of the borrower, including changes in the payment status of borrowers in the group

(o) changes in the entity's credit management approach in relation to the financial instrument; ie based on emerging indicators of changes in the credit risk of the financial instrument, the entity's credit risk management practice is expected to become more active or to be focused on managing the instrument, including the instrument becoming more closely monitored or controlled, or the entity specifically intervening with the borrower.

(p) Other past due information.

- **30 days past due rebuttable presumption:**

  Regardless of the way in which an entity assesses significant increases in credit risk, there is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due.

  - An entity can rebut this presumption if the entity has reasonable and supportable information that is available without undue cost or effort, that demonstrates that the credit risk has not increased significantly since initial recognition even though the contractual payments are more than 30 days past due.

- When an entity determines that there have been significant increases in credit risk before contractual payments are more than 30 days past due, the rebuttable presumption does not apply.

- **Measurement of expected credit losses:**

  - ♦ An entity shall measure expected credit losses of a financial instrument in a way that reflects:

    (a) an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;

    (b) the time value of money; and

    (c) reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

  - ♦ When measuring expected credit losses, an entity need not necessarily identify every possible scenario. However, it shall consider the risk or probability that a credit loss occurs by reflecting the possibility that a credit loss occurs and the possibility that no credit loss occurs, even if the possibility of a credit loss occurring is very low.

  - ♦ The maximum period to consider when measuring expected credit losses is the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period, even if that longer period is consistent with business practice.

  - ♦ **An entity may use practical expedients when measuring expected credit losses.**

    - An example of a practical expedient is the calculation of the expected credit losses on trade receivables using a provision matrix. The entity would use its historical credit loss experience for trade receivables to estimate the 12-month expected credit losses or the lifetime expected credit losses on the financial assets as relevant. A provision matrix might, for example, specify fixed provision rates depending on the number of days that a trade receivable is past due (for example, 1 per cent if not past due, 2 per cent if less than 30 days past due, 3 per cent if more than 30 days but less than 90 days past due, 20 per cent if 90–180 days past due etc).

    - Depending on the diversity of its customer base, the entity would use appropriate groupings if its historical credit loss experience shows significantly different loss patterns for different customer segments. Examples of criteria that might be used to group assets include geographical region, product type, customer rating, collateral or trade credit insurance and type of customer (such as wholesale or retail).

Illustration 30 :12 month expected credit loss – Probability of default approach

Entity A originates a single 10 year amortising loan for CU1 million. Taking into consideration the expectations for instruments with similar credit risk (using reasonable and supportable information that is available without undue cost or effort), the credit risk of the borrower, and *the economic outlook for the next 12 months, Entity A estimates that the loan at initial recognition has a probability of default (PoD) of 0.5 per cent over the next 12 months. Entity A also determines that changes in the 12-month PoD are a reasonable approximation of the changes in the lifetime PoD for determining whether there has been a significant increase in credit risk since initial recognition. Loss given default (LGD) is estimated as 25% of the balance outstanding. Calculate loss allowance.*

Solution

At reporting date, no change in 12-month PoD and entity assesses that there is no significant increase in credit risk since initial recognition – therefore lifetime ECL is not required to be recognised.

Particulars	Details
Loan	₹ 1,000,000 (A)
LGD	25% (B)
PoD – 12 months	0.5% (C)
Loss allowance (for 12-months ECL)	₹ 1,250 (A*B*C)

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Illustration 31: 12 month expected credit loss – Loss rate approach

Bank A originates 2,000 bullet loans with a total gross carrying amount of CU 500,000. Bank A segments its portfolio into borrower groups (Groups X and Y) on the basis of shared credit risk characteristics at initial recognition. Group X comprises 1,000 loans with a gross carrying amount per client of CU 200, for a total gross carrying amount of CU 200,000. Group Y comprises 1,000 loans with a gross carrying amount per client of CU 300, for a total gross carrying amount of CU 300,000. There are no transaction costs and the loan contracts include no options (for example, prepayment or call options), premiums or discounts, points paid, or other fees. Calculate loss rate when

Group	Historic per annum average defaults	Present value of observed loss assumed
X	4	CU 600
Y	2	CU 450

Solution

- Bank A measures expected credit losses on the basis of a loss rate approach for Groups X and Y. In order to develop its loss rates, Bank A considers samples of its own historical default and loss experience for those types of loans.
- In addition, Bank A considers forward-looking information, and updates its historical information for current economic conditions as well as reasonable and supportable forecasts of future economic conditions. Historically, for a population of 1,000 loans in each group, Group X's loss rates are 0.3 per cent, based on four defaults, and historical loss rates for Group Y are 0.15 per cent, based on two defaults.

	Number of clients in sample	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 assumed	Loss rate
Group	A	B	C = A × B	D	E = B × D	F	G = F ÷ C
X	1,000	CU200	CU2,00,000	4	CU800	CU600	0.3%
Y	1,000	CU300	CU3,00,000	2	CU600	CU450	0.15%

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Illustration 32: Life time expected credit losses (provision matrix for short term receivables)

Company M, a manufacturer, has a portfolio of trade receivables of CU30 million in 20X1 and operates only in one geographical region. The customer base consists of a large number of small clients and the trade receivables are categorised by common risk characteristics that are representative of the customers' abilities to pay all amounts due in accordance with the contractual terms. The trade receivables do not have a significant financing component in accordance with Ind AS 115. In accordance with paragraph 5.5.15 of Ind AS 109 the loss allowance for such trade receivables is always measured at an amount equal to lifetime expected credit losses.

Please use the following information of debtors outstanding:

	Gross carrying amount
Current	*CU 15,000,000*
1–30 days past due	*CU 7,500,000*
31–60 days past due	*CU 4,000,000*
61–90 days past due	*CU 2,500,000*
More than 90 days past due	*CU 1,000,000*
	CU 30,000,000

Company M uses following default rates for making provisions:

	Current	***1–30 days past due***	***31–60 days past due***	***61–90 days past due***	***More than 90 days past due***
Default rate	*0.3%*	*1.6%*	*3.6%*	*6.6%*	*10.6%*

Determine the expected credit losses for the portfolio

Solution

To determine the expected credit losses for the portfolio, Company M uses a provision matrix. The provision matrix is based on its historical observed default rates over the expected life of the trade receivables and is adjusted for forward-looking estimates. At every reporting date the historical observed default rates are updated and changes in the forward-looking estimates are analysed. In this case it is forecast that economic conditions will deteriorate over the next year.

On that basis, Company M estimates the following provision matrix:

	Current	1–30 days past due	31–60 days past due	61–90 days past due	More than 90 days past due
Default rate	0.3%	1.6%	3.6%	6.6%	10.6%

The trade receivables from the large number of small customers amount to CU 30 million and are measured using the provision matrix.

	Gross carrying amount	Lifetime expected credit loss allowance (Gross carrying amount x lifetime expected credit loss rate)
Current	CU 15,000,000	CU 45,000
1–30 days past due	CU 7,500,000	CU 120,000
31–60 days past due	CU 4,000,000	CU 144,000
61–90 days past due	CU 2,500,000	CU 165,000
More than 90 days past due	CU 1,000,000	CU 106,000
	CU 30,000,000	**CU 580,000**

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UNIT 4: RECOGNITION AND DERECOGNITION OF FINANCIAL INSTRUMENTS

The concepts of recognition and derecognition of any asset or liability refer to the timing i.e. when is the financial instrument included in an entity's balance sheet (recognition) and when is it removed from the entity's balance sheet (derecognition).

4.1 INITIAL RECOGNITION

As per paragraph 3.1.1 of Ind AS 109, an entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument.

Paragraph B3.1.2 of Ind AS 109 provides certain examples of applying the aforementioned accounting principle:

Nature of contract	Recognition principle – when are assets or liabilities recognised?
Unconditional receivables and payables	When the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash
Firm commitment to purchase or sell goods or services	When at least one of the parties has performed under the agreement i.e. until the ordered goods or services have been shipped, delivered or rendered.
Firm commitment to purchase or sell goods or services designated as measured at fair value through profit or loss (refer note 2 below)	Net fair value is recognised as an asset or a liability on the commitment date
Forward contract	On the commitment date. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero (refer note 1 below). If the net fair value of the right and obligation is not zero, the contract is recognised as an asset or liability.
Option contracts	When the holder or writer becomes a party to the contract (refer note 1 below).
Planned future transactions	Never

Note 1: Generally, no upfront premium is paid by one party in a forward contract to the other at the inception of the contract. This is indicative of the fact that the fair value of a forward contract on inception is approximately zero. On the other hand, the option holder generally pays an upfront premium to the option writer at the inception of the option contract. This provides evidence that there is some fair value of the rights and obligations of the parties at the inception of an options contract.

Note 2: Contracts to buy or sell non-financial assets that can be settled net or by exchanging financial instruments are treated as if they are financial instruments, that is, derivatives unless they were entered into and continued to be held to meet the entity's normal purchase, sale or usage requirements

4.2 REGULAR WAY PURCHASE OR SALE OF FINANCIAL ASSETS

Ind AS 109 defines a regular way purchase or sale as,

- a **purchase or sale** of a financial asset
- under a **contract**
- whose terms require **delivery** of the asset
- within the **time frame**
- established generally by **regulation or convention in the marketplace** concerned

Regular way purchase or sale of financial assets

Trade date accounting

Trade date = date that an entity commits itself to purchase or sell an asset

Settlement date accounting

Settlement date = date that an asset is delivered to or by an entity

- Recognition of an asset to be received and the liability to pay for it
- Derecognition of an asset that is sold, recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment

For instance, on the Bombay Stock Exchange in India, all transactions in all groups of securities in the Equity segment, Fixed Income securities and Government securities are settled on "T+2" basis. In this case, "T" is the trade date and "T+2" is the settlement date i.e. exchange of monies and securities between the buyers and sellers respectively takes place on second business day (excluding Saturdays, Sundays, bank and Exchange trading holidays) after the trade date.

It follows that if a contract is entered into with a broker for purchase or sale of securities which is normally traded on the Bombay Stock Exchange, with a settlement period that differs from the norms mentioned above, it would not be regarded as a regular way purchase or sale.

When trade date accounting is applied, the buyer of a financial asset recognises the financial asset and its liability to pay on the trade date itself. Correspondingly, the seller derecognises the financial asset and recognises any gain or loss on sale on the trade date. The buyer subsequently measures the financial asset in accordance with its classification category.

When settlement date accounting is applied, a **buyer of financial asset accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date** in the same way as it accounts for the acquired asset. In other words,

- assets measured at amortised cost - change in value is not recognised;
- assets classified as financial assets measured at fair value through profit or loss (whether mandatorily or designated) – change in value is recognised in profit or loss;
- financial assets measured at fair value through other comprehensive income (including investments in equity instruments for which irrevocable option is selected) – change in fair value is recognised in other comprehensive income.

Correspondingly, the seller of a financial asset derecognises the same at the settlement date and does not recognise any fair value changes between the trade date and settlement date.

An entity shall apply the same method consistently for all purchases and sales of financial assets that are classified in the same way in accordance with Ind AS 109.

Illustration 1: Regular way contracts: forward contracts

ST Ltd. enters into a forward contract to purchase 10 lakh shares of ABC Ltd. in a month's time for ₹ 50 per share. This contract is entered into with a broker, Mr. AG and not through regular trading mode in a stock exchange. The contract requires Mr. AG to deliver the shares to ST Ltd. upon payment of agreed consideration. Shares of ABC Ltd. are traded on a stock exchange. Regular way delivery is two days. Assess the forward contract.

Solution

In this case, the forward contract is not a regular way transaction and hence must be accounted for as a derivative i.e. between the date of entering into the contract to the date of delivery, all fair value changes are recognised in profit or loss.

On the other hand, if the forward contract is a regular way transaction, such fair value changes are recognised in other comprehensive income if share of ABC Ltd. are equity instruments and not held for trading.

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Illustration 2: Regular way contracts: option contracts

NKT Ltd. purchases a call option in a public market permitting it to purchase 100 shares of VT Ltd. at any time over the next one month at a price of ₹ 1,000 per share. If NKT Ltd. exercises its option, it has 7 days to settle the transaction according to regulation or convention in the options market. VT Ltd.'s shares are traded in an active public market that requires two-day settlement.

Solution

In this case, the options contract is a regular way transaction as the settlement of the option is governed by regulation or convention in the marketplace for options. Fair value changes between the trade date and settlement date are recognised in other comprehensive income if share of VT Ltd. are equity instruments and not held for trading by NKT Ltd.

The illustrations below explain the flow of journal entries in case of trade date accounting and settlement date accounting for regular way purchase and sale of financial assets.

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Illustration 3: Regular way purchase of financial asset

On 1 January 20X1, X Ltd. enters into a contract to purchase a financial asset for ₹ 10 lakhs, which is its fair value on trade date. On 4 January 20X1 (settlement date), the fair value of the asset is ₹ 10.5 lakhs. The amounts to be recorded for the financial asset will depend on how it is classified and whether trade date or settlement date accounting is used. Pass necessary journal entries.

Solution

Journal Entries in the Buyer's Books

Trade date accounting

Dr. / Cr.	Particulars	Amortised cost	Fair value through P&L	Fair value through OCI
1 January 20X1				
Dr.	Financial asset	10,00,000	10,00,000	10,00,000
Cr.	Financial liability (to pay)	(10,00,000)	(10,00,000)	(10,00,000)
4 January 20X1				
Dr.	Financial asset	-	50,000	50,000
Dr.	Financial liability (to pay)	10,00,000	10,00,000	10,00,000
Cr.	Profit or loss	-	(50,000)	-
Cr.	Other comprehensive income	-	-	(50,000)
Cr.	Cash	(10,00,000)	(10,00,000)	(10,00,000)

Settlement date accounting

Dr. / Cr.	Particulars	Amortised cost	Fair value through P&L	Fair value through OCI
4 January 20X1				
Dr.	Financial asset	10,00,000	10,50,000	10,50,000
Cr.	Profit or loss	-	(50,000)	-
Cr.	Other comprehensive income	-	-	(50,000)
Cr.	Cash	(10,00,000)	(10,00,000)	(10,00,000)

The above mentioned accounting principles apply only to financial assets and Ind AS 109 does not contain any such principles for financial liabilities.

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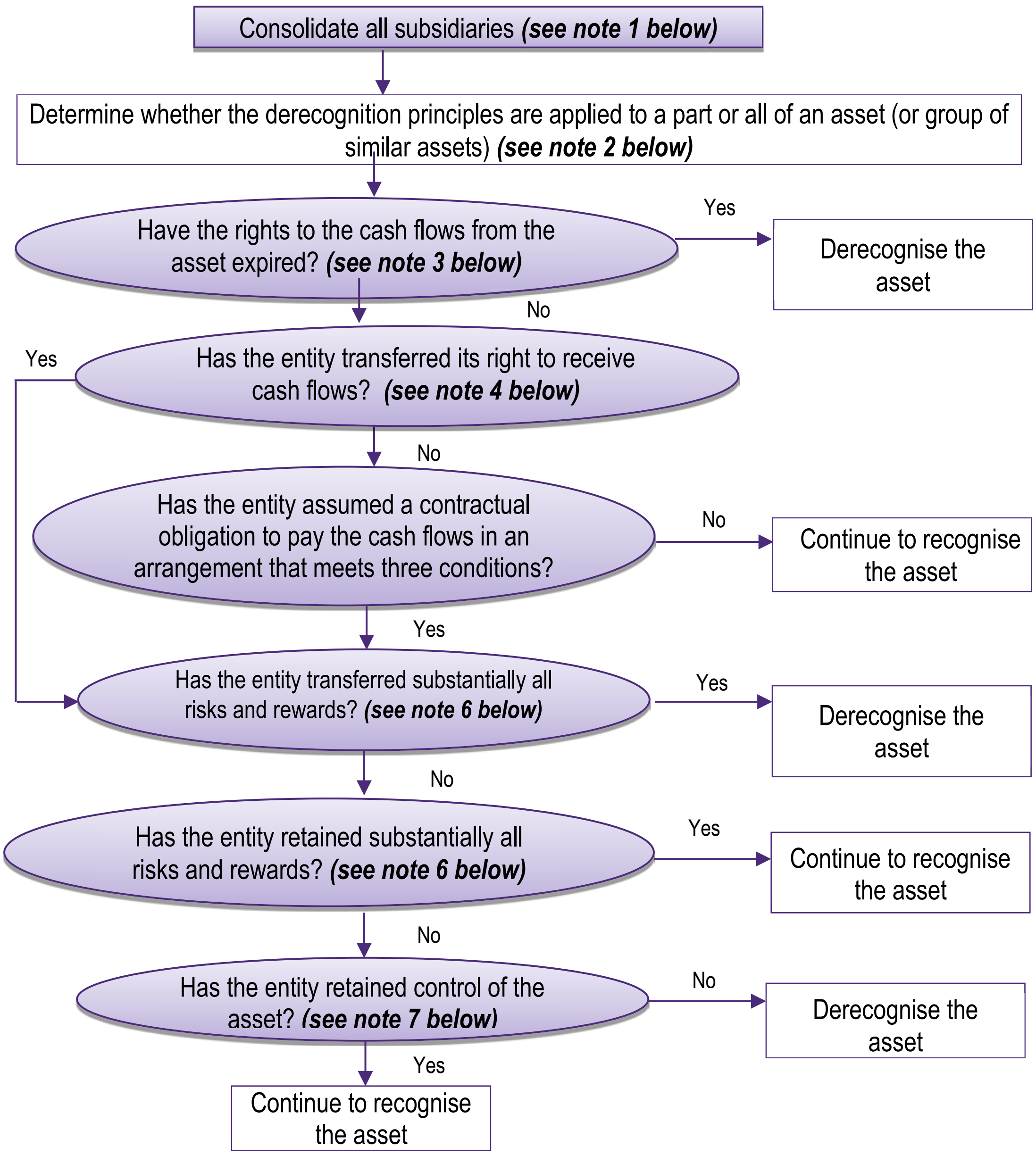
4.3 DERECOGNITION OF FINANCIAL ASSETS

In simple words, derecognition refers to the timing of removing a financial asset from the balance sheet. To take an example, if a company gets its trade receivables discounted from a bank, it would need to determine whether it can remove those trade receivables from its balance sheet.

Paragraph B3.2.1 of Ind AS 109 provides a step-by-step flowchart for making this determination.



Notes:

1. In consolidated financial statements, accounting principles for derecognition are applied at a consolidated level. Hence, an entity first consolidates all subsidiaries in accordance with Ind AS 110 and then applies those requirements to the resulting group. (Ind AS 109.3.2.1)

   The importance of this criteria is that sometimes sales of financial assets are made to entities which are specifically designed for this purpose. In those circumstances, it would be inappropriate to derecognise the financial asset if the purchaser entity is indirectly controlled by the seller entity.

2. Let's understand this step using a few fact patterns:

   Illustration 4: Part of a financial asset

   State whether the derecognition principles will be applied or not.

   i. Interest strip of an interest-bearing financial asset i.e. the part entitles its holder to interest cash flows of a financial asset

   ii. Dividend strip of an equity share i.e. the part entitles its holder to only dividends arising from an equity share

   iii. Cash flows (principal and asset) upto a certain tenure or first right on a proportion of cash flows of an amortising financial asset. Say, the part entitles its holder to first 80% of the cash flows or cash flows for first 4 of the 6 years' tenure.

   Solution

   Derecognition requirements are applied to a part of a financial asset if that part meets **any of the following three** conditions:

   a) The part comprises only **specifically identified cash flows** from a financial asset (or a group of similar financial assets).

      For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, derecognition principles are applied to the interest cash flows

   b) The part comprises only a **fully proportionate (pro rata) share of the cash flows** from a financial asset (or a group of similar financial assets).

      For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of all cash flows of a debt instrument, derecognition principles are applied to 90 per cent of those cash flows.

   c) The part comprises only a **fully proportionate (pro rata) share of specifically identified cash flows** from a financial asset (or a group of similar financial assets).

For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of interest cash flows from a financial asset, derecognition principles are applied to 90 per cent of those interest cash flows.

The example of a part of a financial asset at (iii) in Illustration 4 above will not qualify conditions at (b) and (c) above since it does not represent pro rata share of all or specifically identified cash flows.

In (b) and (c) above, if there is more than one counterparty, each counterparty is not required to have a proportionate share of the cash flows provided that the transferring entity has a fully proportionate share.

In all other cases, derecognition principles are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety).

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Illustration 5: Part of a financial asset

State whether the derecognition principles will be applied or not.

i. Entity Y transfers the rights to the first or the last 90 per cent of cash collections from a financial asset (or a group of financial assets)

ii. Entity Z transfers the rights to 90 per cent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8 per cent of the principal amount of the receivables.

Solution

In the above circumstances, Entity Y and Entity Z need to apply the derecognition requirements to the financial asset (or a group of similar financial assets) in its entirety.

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3. Cash flows from a financial asset expire upon payment of entire due amount or the legal release of the debtor by the creditor from the obligation to pay. In case of derivatives, this condition is considered met when, for example, contractual exercise period of an option expires and option is not exercised.

   Ind AS 109 contains elaborate guidance on when renegotiation of the terms of a financial liability results in derecognition thereof. Refer paragraph “Exchange of financial liability instruments” for more details on the same. However, in respect of financial assets, such elaborate guidance has not been provided.

   One may use the principles of quantitative and qualitative tests prescribed for financial liabilities to evaluate whether renegotiation of the terms of a financial asset results in derecognition or not.

We discuss below a few circumstances wherein renegotiation does result in "expiry of right to receive cash flows":

- Agreeing to a moratorium period for repayment of principal or extension of the overall tenor of the loan.
- Substantial reduction in the interest rates
- Agreeing to a right to convert loan or a part thereof into equity shares after a certain period of time

4. Examples of transfer of rights to receive cash flows include sale of a financial asset, such as an investment in a debenture or assignment of a receivable (like factoring arrangements with banks or financial institutions). Refer comprehensive examples below on debt factoring and invoice discounting.

5. In some situations, though an entity retains the contractual rights to receive cash flows of a financial asset ('original asset'), it does assume a contractual obligation to pay those cash flows to one or more entities ('eventual recipients').

   For example, securitisation arrangements are a common form of transfer of financial assets in India. In these arrangements, the originator of a financial asset, say a bank or a NBFC, settle a Trust and transfer a portfolio of financial assets to that Trust. Thereafter, securities of that Trust are issued to unrelated parties or investors. Such arrangements are often "pass through" arrangements, in the sense that the originator or the Trust retains the rights to receive cash flows from the financial asset, but they have a simultaneous obligation to pay those cash flows to a recipient.

   As per paragraph 3.2.5 of Ind AS 109, **all of the** following conditions need to be met in such situations for the transaction to qualify as a "transfer":

   - The entity has **no obligation to pay amounts** to the eventual recipients **unless it collects equivalent amounts** from the original asset.

     Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition. However, existence of guarantees or options that allow the transferee to transfer receivables back to the entity and other recourse arrangements are likely to conflict with this condition.

   - The entity is **prohibited** by the terms of the transfer contract **from selling or pledging the original asset** other than as security to the eventual recipients for the obligation to pay them cash flows
   - The entity has an **obligation to remit any cash flows** it collects on behalf of the eventual recipients **without material delay**

- entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents during the short settlement period, and interest earned on such investments is passed to the eventual recipients.

  The standard does not define the word "material" in this condition. Therefore, the same should be understood in common trade parlance.

Illustration 6: Proportionate "pass through" arrangement

Entity A makes a five-year interest-bearing loan (the 'original asset') of ₹ 100 crores to Entity B. Entity A settles a Trust and transfers the loan to that Trust. The Trust issues participatory notes to an investor, Entity C, that entitle the investor to the cash flows from the asset.

As per Trust's agreement with Entity C, in exchange for a cash payment of ₹ 90 crores, Trust will pass to Entity C 90% of all principal and interest payments collected from Entity B (as, when and if collected). Trust accepts no obligation to make any payments to Entity C other than 90% of exactly what has been received from Entity B. Trust provides no guarantee to Entity C about the performance of the loan and has no rights to retain 90% of the cash collected from Entity B nor any obligation to pay cash to Entity C if cash has not been received from Entity B.

Compute the amount to be dercognised.

Solution

If the three conditions are met, the proportion sold is derecognised, provided the entity has transferred substantially all the risks and rewards of ownership. Thus, Entity A would report a loan asset of ₹ 10 crores and derecognise ₹ 90 crores.

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6. Let's illustrate the "risks and rewards" test with certain examples given in application guidance of Ind AS 109:

   <u>Examples of when an entity **has transferred** substantially all the risks and rewards of ownership</u> are:

   a) an unconditional sale of a financial asset;

   b) a sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and

   c) a sale of a financial asset together with a put or call option that is deeply out of the money (ie an option that is so far out of the money it is highly unlikely to go into the money before expiry).

   <u>Examples of when an entity has retained substantially all the risks and rewards of ownership</u> are:

   a) a sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return;

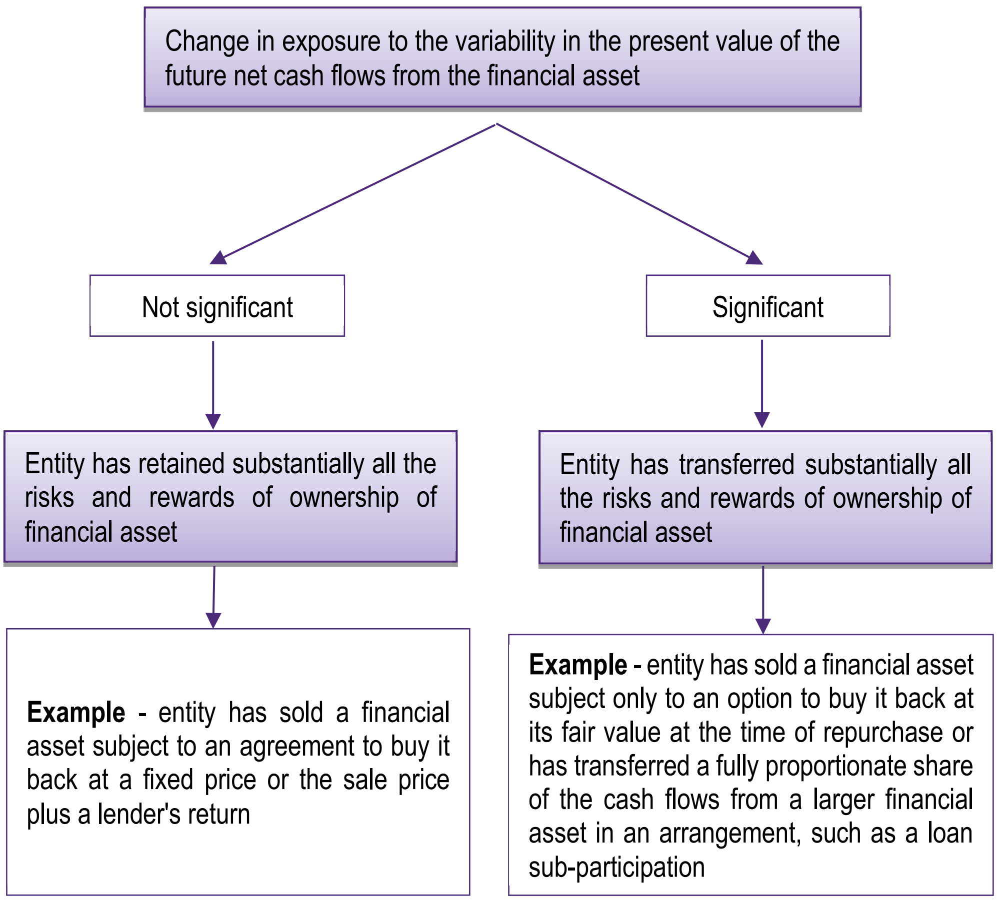
b) a securities lending agreement;

c) a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity;

d) a sale of a financial asset together with a deep in-the-money put or call option (ie an option that is so far in the money that it is highly unlikely to go out of the money before expiry); and

e) a sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.

Paragraph 3.2.7 of Ind AS 109 provides the guidance on **"risks and rewards" test**



In evaluating the extent to which risks and rewards are transferred or retained, risks and rewards that are reasonably expected to be significant in practice should be considered.

So, what is the most significant risk in a portfolio of short term receivables? It is usually credit risk i.e. the risk that the customer will default. Therefore, an **arrangement that involves the transferee having full recourse to the transferor for credit losses will "fail" the risks**

and rewards tests. An arrangement in which the transferee has no recourse to the transferor for credit losses will generally "pass" the risks and rewards tests.

What are the most significant risks in longer term receivables? Well, interest rate risk and slow payment risk are fairly significant in those cases. An arrangement in which the entity continues to pay interest to the transferee until the underlying debtor settles involves the transferee retaining the risk of slow payment.

7. Whether the entity has retained control of the transferred asset depends on the **transferee's ability to sell the asset**. If the transferee,

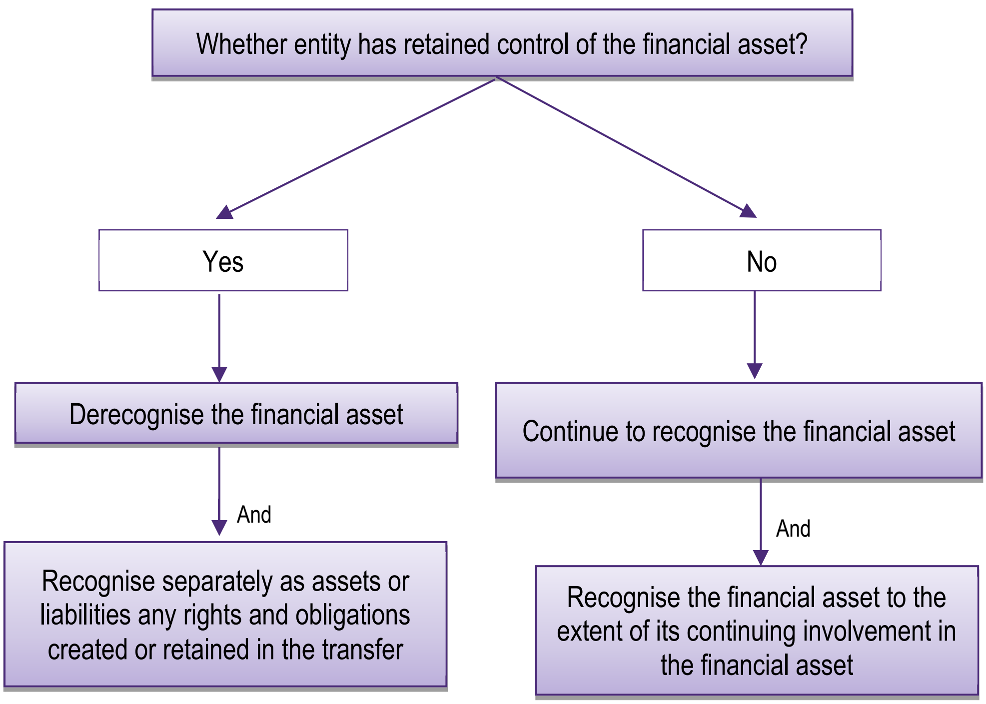
   i. has the practical ability to sell the asset in its entirety to an unrelated third party, and

   ii. is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer

   the entity has not retained control.

   In all other cases, the entity has retained control.

   The accounting treatment as a consequence of this decision is as below:



The critical question is what the transferee is able to do in practice, not what contractual rights the transferee has concerning what it can do with the transferred asset or what contractual prohibitions exist.

Paragraphs B3.2.7 and 3.2.8 give examples of certain situations in which transferee is evaluated to have such practical ability and situations in which it doesn't have.

Example of situation when transferee has practical ability to sell the financial asset

Transferred asset is subject to an option that allows the entity to repurchase it and it is traded in an active market: transferee has the practical ability to sell the financial asset as it can readily obtain the transferred asset in the market if the option is exercised.

Examples of situations when transferee doesn't have practical ability to sell the financial asset

- Transferred asset is subject to an option that allows the entity to repurchase it and it is not traded in an active market: transferee doesn't have the practical ability to sell the financial asset as it cannot readily obtain the transferred asset in the market if the option is exercised.
- A put option or guarantee with respect to the transferred asset which is sufficiently valuable in the sense that it constrains the transferee from selling the transferred asset because the transferee would, in practice, not sell the transferred asset to a third party without attaching a similar option or other restrictive conditions. Instead, the transferee would hold the transferred asset so as to obtain payments under the guarantee or put option. In this situation, the transferor has retained control of the transferred asset.

Illustrations on application of derecognition principles

Paragraph B3.2.16 of Ind AS 109 provides certain illustrations which are summarised below:

Illustration 7: Repurchase agreements

A financial asset is sold under repurchase agreement. The repurchase price as per that agreement is (a) fixed price or (b) sale price plus a lender's return. Let's look at three alternate scenarios:

i. Repurchase agreement is for the same financial asset.

ii. Repurchase agreement is for substantially the same asset

iii. Repurchase agreement provides the transferee a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date.

State whether the derecognition principles will be applied or not.

Solution

In each of these scenarios, the transferred financial asset is not derecognised because the transferor retains substantially all the risks and rewards of ownership.

Let's look at another scenario:

Repurchase agreement provides the transferor only a right of first refusal to repurchase the transferred asset at fair value if the transferee subsequently sells it

In this scenario, the transferred financial asset is derecognised because the transferor has transferred substantially all the risks and rewards of ownership.

*****

Illustration 8: Put options on transferred financial assets

A financial asset is sold and the transferee has a put option. Let's look at some alternate scenarios:

i. Put option is deeply in the money

ii. Put option is deeply out of the money.

State whether the derecognition principles will be applied or not.

Solution

In the first scenario, the transferred asset does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. However, in the second scenario, the transferor has transferred substantially all the risks and rewards of ownership.

*****

Illustration 9: Call options on transferred financial assets

A financial asset is sold and the transferor has a call option. Let's look at some alternate scenarios:

i. Call option is deeply in the money

ii Call option is deeply out of the money.

What it the transferor holds a call option on an asset that is readily obtainable in the market?
iii Call option is neither deeply in the money nor deeply out of the money

State whether thederecognition principles will be applied or not.

Solution

In the first scenario, the transferred asset does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. However, in the second scenario, the transferor has transferred substantially all the risks and rewards of ownership.

In the third scenario, the asset is derecognised. This is because the entity (i) has neither retained nor transferred substantially all the risks and rewards of ownership, and (ii) has not retained control.

*****

Illustration 10: Amortising interest rate swaps

An entity may transfer to a transferee a fixed rate financial asset that is paid off over time, and enter into an amortising interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount.

Scenarios:

i. Notional amount of the swap amortises so that it equals the principal amount of the transferred financial asset outstanding at any point in time.

ii. Amortisation of the notional amount of the swap is not linked to the principal amount outstanding of the transferred asset.

State whether the derecognition principles will be applied or not.

Solution

In the first scenario, the swap would generally result in the entity retaining substantial prepayment risk, in which case the entity either continues to recognise all of the transferred asset or continues to recognise the transferred asset to the extent of its continuing involvement.

Such a swap would not result in the entity retaining prepayment risk on the asset. Hence, it would not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on interest payments being made on the transferred asset and the swap does not result in the entity retaining any other significant risks and rewards of ownership on the transferred asset.

*****

4.3.1 Accounting treatment of transfers

4.3.1.1Transfers that qualify for derecognition

If the arrangement results in de-recognition of the financial asset in its entirety:

- in the case of assets included in the "fair value through other comprehensive income" category, any gain or loss previously recorded in equity is recycled to the statement of comprehensive income;
- any new financial assets obtained, financial liabilities assumed and any servicing obligations are recognised at fair value. new asset is part of the proceeds of sale. Any liability assumed, even if it is related to the transferred asset, is a reduction of the sales proceeds.
- the difference between the carrying amount and the consideration received is recognised in the statement of comprehensive income.

Illustration 11: Assignment of receivables

ST Ltd. assigns its trade receivables to AT Ltd. The carrying amount of the receivables is ₹10,00,000. The consideration received in exchange of this assignment is ₹9,00,000. Customers have been instructed to deposit the amounts directly in a bank account for the benefit of AT Ltd. AT Ltd. has no recourse to ST Ltd. in case of any shortfalls in collections.

State whether the derecognition principles will be applied or not.

Solution

In this situation, ST Ltd. has transferred the rights to contractual cash flows and has also transferred substantially all the risks and rewards of ownership (credit risk being the most significant risk in this situation).

Accordingly, ST Ltd. derecognises the financial asset and recognises ₹ 1,00,000, the difference between consideration received and carrying amount, as an expense in the statement of profit or loss.

*****

4.3.1.2Transfers that do not qualify for derecognition

If a transfer does not result in derecognition because the entity has retained substantially all the risks and rewards of ownership of the transferred asset (for example, in a situation when the transferor guarantees transferee against any default losses), the entity shall,

- continue to recognise the transferred asset in its entirety,
- recognise a financial liability for the consideration received, recognised at fair value less any transaction costs incurred. The liability is subsequently measured at amortised cost using the effective interest method, and
- in subsequent periods, recognise any income on the transferred asset and any expense incurred on the financial liability.

4.3.1.3 Continuing involvement in transferred assets (partial de-recognition)

If an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset, and retains control of the transferred asset,

- the entity **continues to recognise the transferred asset to the extent of its continuing involvement**. The extent of the entity's continuing involvement in the transferred asset is the extent to which it is exposed to changes in the value of the transferred asset.
  - ♦ *Guarantees for transferred asset*

    The extent of the entity's continuing involvement is the lower of

    (i) the amount of the asset, and

(ii) the maximum amount of the consideration received that the entity could be required to repay ('the guarantee amount').

Illustration 12A: Debt factoring with recourse – continuing involvement asset

Entity C agrees with factoring company D to enter into a debt factoring arrangement. Under the terms of the arrangement, the factoring company B agrees to pay ₹ 91.5 crores, less a servicing charge of ₹ 1.5 crores (net proceeds of ₹ 90 crores), in exchange for 100% of the cash flows from short-term receivables.

The receivables have a face value of ₹ 100 crores and carrying amount of ₹ 95 crores.

The customers will be instructed to pay the amounts owed into a bank account of the factoring company. Entity C also writes a guarantee to the factoring company under which it will reimburse any credit losses upto ₹ 5 crores, over and above the expected credit losses of ₹ 5 crores and losses of up to ₹ 15 crores are considered reasonably possible. The guarantee is estimated to have a fair value of ₹ 0.5 crores. Comment.

Solution

In this situation, the "continuing involvement asset" will be recognised at ₹ 5 crores i.e. lower of:

i. the amount of the asset – ₹ 95 crores

ii. the guarantee amount – ₹ 5 crores

- the entity also **recognises an associated liability** that is measured in such a way that the net carrying amount of the transferred asset and the associated liability is:
  - the amortised cost of the rights and obligations retained by the entity, if the transferred asset is measured at amortised cost, or
  - equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, if the transferred asset is measured at fair value.

  Recognised changes in the fair value of the transferred asset and the associated liability are accounted for consistently with each other and shall not be offset. If the transferred asset is measured at amortised cost, the option in this Standard to designate a financial liability as at fair value through profit or loss is not applicable to the associated liability.

  In case of guarantees, as per the application guidance in Ind AS 109, the associated liability is initially measured at

  - the guarantee amount plus
  - the fair value of the guarantee (which is normally the consideration received for the guarantee).

*****

Illustration 12B: Debt factoring with recourse – associated liability

Continuing illustration 12A, the associated liability is recognised at ₹ 5.5 crores, as below:

i. *the guarantee amount (i.e. ₹ 5 crores) plus*

ii. *the fair value of the guarantee (i.e. ₹ 0.5 crores). Comment*

Solution

- If an entity's continuing involvement is in only a part of a financial asset, the entity **allocates the previous carrying amount** of the financial asset **between the part it continues to recognise under continuing involvement, and the part it no longer recognises** on the basis of the relative fair values of those parts on the date of the transfer. The difference between:
    - the carrying amount (measured at the date of derecognition) allocated to the part that is no longer recognised and
    - the consideration received for the part no longer recognised

  shall be recognised in profit or loss.

*****

Illustration 12C: Debt factoring with recourse – gain or loss on derecognition

Pass the necessary Journal Entry

Solution

The journal entries passed by Entity C on the date of derecognition is as below:

Cash	Dr.	₹ 90 crores	
Loss on derecognition	Dr.	₹ 5.5 crores	
Continuing involvement asset	Dr.	₹ 5 crores	
To Receivables			₹ 95 crores
To Associated liability			₹ 5.5 crores

- the entity shall **continue to recognise any income arising on the transferred asset to the extent of its continuing involvement** and shall recognise any expense incurred on the associated liability

  In the example above, the guarantee liability of ₹ 0.5 crores shall be amortised in profit or loss over the underlying period.

*****

4.4 DERECOGNITION OF FINANCIAL LIABILITIES

4.4.1 General principles

4.4.1.1 Timing of derecognition

An entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires. (Paragraph 3.3.1 of Ind AS 109)

A financial liability (or part of it) is extinguished when the debtor either:

(a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or

(b) is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met.)

(Paragraph B3.3.1 of Ind AS 109)

If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognise the debt obligation unless the condition in paragraph B3.3.1(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognises a new debt obligation to the third party. (Paragraph B3.3.4 of Ind AS 109)

4.4.1.2Accounting treatment for extinguishment

The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss. (Paragraph 3.3.3 of Ind AS 109)

Further, in some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults. In these circumstances the debtor:

(a) recognises a new financial liability based on the fair value of its obligation for the guarantee, and

(b) recognises a gain or loss based on the difference between (i) any proceeds paid and (ii) the carrying amount of the original financial liability less the fair value of the new financial liability.

4.4.2 Exchange of financial liability instruments

Many times entities re-negotiate terms of their existing debt with the lenders. In India, this is popularly known as "Strategic Debt Restructuring" or SDR. Sometimes, entities approach their lenders to renegotiate terms of their debt, when they want to take advantage of the falling interest rate regime.

In accounting terms, such situations need to be evaluated to determine whether the original debt is extinguished.

As per paragraph 3.3.2 of Ind AS 109, an exchange between an existing borrower and lender of debt instruments with **substantially different terms** shall be accounted for as:

- an extinguishment of the original financial liability, and
- the recognition of a new financial liability.

Similarly, a **substantial modification** of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted as mentioned above.

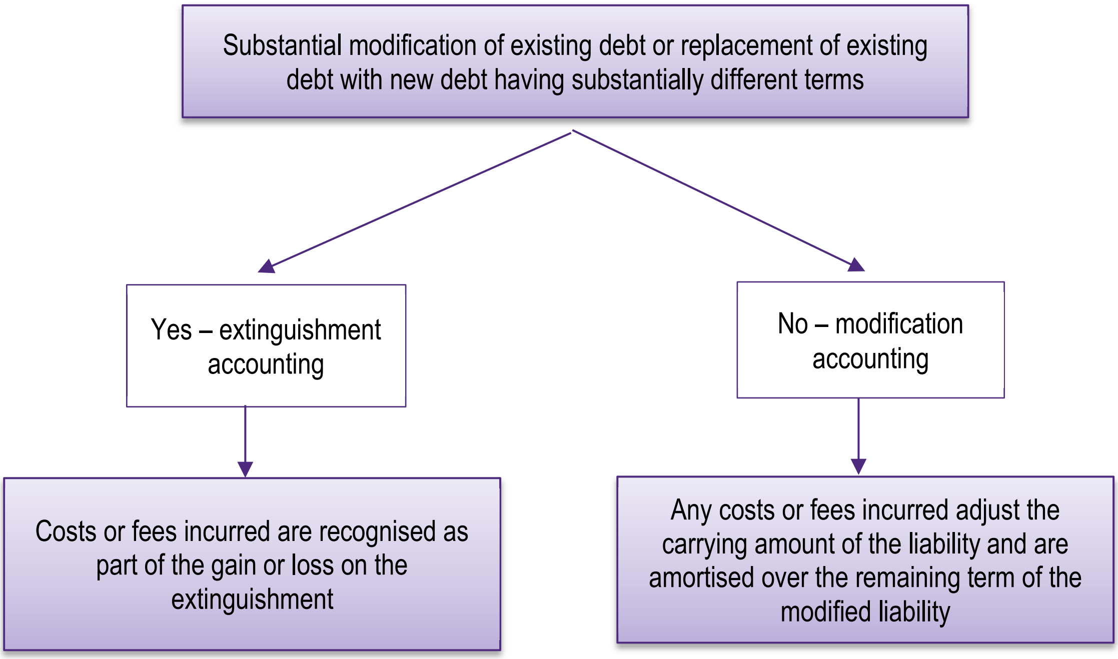
As per application guidance in paragraph B3.3.6 of Ind AS 109, the **terms are substantially different if:**

(A)		(B)	
Present value of: • cash flows under the new terms, • any fees paid • net of any fees received discounted using the original effective interest rate	LESS	Discounted present value of the remaining cash flows of the original financial liability	Is greater than or equal to 10% of (B)

4.4.2.1 Accounting treatment

If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment.

If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.



1. Extinguishment accounting

If the 10% test is passed, principle of "extinguishment accounting" are applied, that is:

- de-recognition of the existing liability
- recognition of the new or modified liability at its fair value (net of any fees incurred directly related to the new liability)
- recognition of a gain or loss equal to the difference between the carrying value of the old liability and the fair value of the new one
- recognising any incremental costs or fees incurred for modification (and not for the new liability), and any consideration paid or received, in profit or loss
- calculating a new effective interest rate for the modified liability, which is then used in future periods.

Fair value of the new or modified liability is estimated based on the expected future cash flows of the modified liability, discounted using the interest rate at which the entity could raise debt with similar terms and conditions in the market.

Example: Extinguishment accounting

On 1 January 20X0, XYZ Ltd. issues 10 year bonds for ₹ 10,00,000, bearing interest at 10% (payable annually on 31st December each year). The bonds are redeemable on 31 December 20X9 for ₹ 10,00,000. No costs or fees are incurred. The effective interest rate is therefore 10%. On 1 January 20X5 (i.e. after 5 years) XYZ Ltd. and the bondholders agree to a modification in accordance with which:

- the term is extended to 31 December 20Y1;
- interest payments are reduced to 5% p.a.;
- the bonds are redeemable on 31 December 20Y1 for ₹ 15,00,000; and
- legal and other fees of ₹ 1,00,000 are incurred.

XYZ Ltd. determines that the market interest rate on 1 January 20X5 for borrowings on similar terms is 11%.

The repayment schedule for the original debt till the date of renegotiation is as below:

Date / year ended	Opening balance	Interest accrual	Cash flows	Closing balance
1 January 20X0	10,00,000	1,00,000	(100,000)	10,00,000
31 December 20X0	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X1	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X2	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X3	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X4	10,00,000	1,00,000	(1,00,000)	10,00,000

On 1 January 20X5, the discounted present value of the remaining cash flows of the original financial liability is ₹ 10,00,000.

On this date, XYZ Ltd. will compute the present value of:

- cash flows under the new terms – i.e. ₹ 15,00,000 payable on 31 December 20Y1 and ₹ 50,000 payable for each of the 7 years ending 31 December 20Y1.
- any fee paid (net of any fee received) – i.e. ₹ 1,00,000

using the original effective interest rate of 10%.

The total of these amounts to ₹ 11,13,158 (Refer Working Note). This differs from the discounted present value of the remaining cash flows of the original financial liability by 11.32% i.e. by more than 10%. Hence, extinguishment accounting applies.

The next step is to estimate the fair value of the modified liability. This is determined as the present value of the future cash flows (interest and principal), using an interest rate of 11% (the market rate at which XYZ Ltd. could issue new bonds with similar terms). The estimated fair value on this basis is ₹ 958,097 (Refer Working Note). A gain or loss on modification is then determined as:

Gain (loss) = carrying value of existing liability - fair value of modified liability - fees and costs incurred i.e. ₹ 10,00,000 – ₹ 9,58,097 – ₹ 1,00,000 = Loss of ₹ 58,097

Working Note:

Year	Discount factor @ 10%	Discount factor @ 11%
1	0.909091	0.900901
2	0.826446	0.811622
3	0.751315	0.731191
4	0.683013	0.658731
5	0.620921	0.593451
6	0.564474	0.534641
7	0.513158	0.481658
Annuity	4.868419	4.712196

Amount	Discounting factor @ 10%	Present value	Discounting factor @ 11%	Present value
15,00,000	0.513158	7,69,737	0.481658	7,22,487
1,00,000		1,00,000		
50,000 for 7 years	4.868419	2,43,421	4.712196	2,35,610
		11,13,158		9,58,097
PV of original cash flows @ original EIR		(10,00,000)		
Difference		1,13,158		
Difference %		11.32%		

Modification accounting

Ind AS 109 is not clear as to the accounting treatment if the 10% test is failed. Two alternate approaches are therefore possible:

Approach 1: Recognition of gain or loss on date of modification

Under this approach, the difference between:

- discounted present value of the remaining cash flows of the original financial liability, and
- discounted present value of the remaining cash flows of the new financial liability

both computed using original effective interest rate,

is recognized in profit or loss. In addition, any fees or costs incurred will also be recognized in profit or loss.

Approach 2: Amortisation of gain or loss on date of modification

Under this approach,

- the fees or costs incurred are netted against the existing liability;
- the effective interest rate is recalculated. This is the rate which discounts the future cash flows as per modified contractual terms to the adjusted carrying amount mentioned above
- the adjusted effective interest rate is used to determine the amortised cost and interest expense in future periods

Example: Modification accounting

On 1 January 20X0, XYZ Ltd. issues 10 year bonds for ₹ 1,000,000, bearing interest at 10% (payable annually on 31st December each year). The bonds are redeemable on 31 December 20X9 for ₹ 1,000,000. No costs or fees are incurred. The effective interest rate is therefore 10%. On 1 January 20X5 (i.e. after 5 years) XYZ Ltd. and the bondholders agree to a modification in accordance with which:

- no further interest payments are made
- the bonds are redeemed on the original due date (31 December 20X9) for ₹ 1,600,000;
- legal and other fees of ₹ 50,000 are incurred.

The repayment schedule for the original debt till the date of renegotiation is as below:

Date / year ended	Opening balance	Interest accrual	Cash flows	Closing balance
1 January 20X0	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X1	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X2	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X3	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X4	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X5	10,00,000	1,00,000	(1,00,000)	10,00,000

On 1 January 20X5, the discounted present value of the remaining cash flows of the original financial liability is ₹ 10,00,000.

On this date, XYZ Ltd. will compute the present value of:

i. cash flows under the new terms – i.e. ₹ 16,00,000 payable on 31 December 20X9

ii. any fees paid (net of any fees received) – i.e. ₹ 50,000

using the original effective interest rate of 10%.

The total of these amounts to ₹ 10,43,474 (Refer Working Note). This differs from the discounted present value of the remaining cash flows of the original financial liability by 4.35% i.e. by less than 10%. Hence, modification accounting applies.

On this basis:

i. the fees paid of ₹ 50,000 are netted against the existing liability of ₹ 10,00,000, resulting in an adjusted carrying amount of ₹ 9,50,000;

ii. the effective interest rate (EIR) is recalculated. This is the rate which discounts the future cash flows (₹ 16,00,000 in five years' time) to the adjusted carrying amount of ₹ 9,50,000. The adjusted EIR is 10.99%

iii. the adjusted EIR is used to determine the amortised cost and interest expense in future periods.

Working Note:

For testing extinguishment -

Cash flows under new terms	16,00,000
PV as at 01 January 20x5	
Revised cash flows@ original EIR	9,93,474
Fees incurred	50,000
PV of revised cash flows @ original EIR	10,43,474
PV of original cash flows @ original EIR	(10,00,000)
Difference	43,474
Difference %	4%
Less than 10% - Indicates modification	

Accounting for revised cash flows @ original EIR

Year	Opening balance	Interest	Payment	Closing balance
0	10,00,000	-	-50,000	9,50,000
1	9,50,000	1,04,405	0	10,54,405
2	10,54,405	1,15,879	0	11,70,284
3	11,70,284	1,28,614	0	12,98,898
4	12,98,898	1,42,749	0	14,41,647
5	14,41,647	1,58,353*	-16,00,000	-
* Difference is due to approximation				

4.4.3 Debt for equity swaps

A debtor and creditor might renegotiate the terms of a financial liability with the result that the debtor extinguishes the liability fully or partially by issuing equity instruments to the creditor. These transactions are sometimes referred to as 'debt for equity swaps'.

Appendix D to Ind AS 109, "Extinguishing Financial Liabilities with Equity Instruments" deals with accounting for such situations.

It must be noted that these accounting principles do not apply in following situations:

- the creditor is also a direct or indirect shareholder and is acting in its capacity as a direct or indirect existing shareholder
- the creditor and the entity are controlled by the same party or parties before and after the transaction and the substance of the transaction includes an equity distribution by, or contribution to, the entity
- extinguishing the financial liability by issuing equity shares is in accordance with the original terms of the financial liability

The accounting principles are summarised below:

- An entity shall **remove a financial liability** (or part of a financial liability) from its balance sheet when, and only **when, it is extinguished** in accordance with derecognition principles mentioned above
- When **equity instruments issued to a creditor** to extinguish all or part of a financial liability are recognised initially, an entity shall **measure them at the fair value** of the equity instruments issued, unless that fair value cannot be reliably measured.
- **If the fair value of the equity instruments issued cannot be reliably measured** then the equity instruments shall be measured to reflect the **fair value of the financial liability** extinguished.
- **If only part of the financial liability is extinguished**, the entity shall assess whether some of the consideration paid relates to a modification of the terms of the liability that remains outstanding. If part of the consideration paid **does relate to a modification of the terms** of the remaining part of the liability, the entity shall allocate the consideration paid between the part of the liability extinguished and the part of the liability that remains outstanding.
- The consideration allocated to the remaining liability shall form part of the assessment of whether the terms of that remaining liability have been substantially modified. **If the remaining liability has been substantially modified, the entity shall account for the modification as the extinguishment of the original liability and the recognition of a new liability**.
- The **difference** between the carrying amount of the financial liability (or part of a financial liability) extinguished, and the consideration paid, shall be **recognised in profit or loss.**

Example : Extinguishment of part of a financial liability through issue of equity instruments

JK Ltd. has an outstanding unsecured loan of ₹ 90 crores to a bank. The effective interest rate (EIR) of this loan is 10%. Owing to financial difficulties, JK Ltd. is unable to service the debt and approaches the bank for a settlement.

The bank offers the following terms which are accepted by JK Ltd.:

- 2/3rd of the debt is unsustainable and hence will be converted into 70% equity interest in JK Ltd. The fair value of net assets of JK Ltd. is ₹ 80 crores.
- 1/3rd of the debt is sustainable and the bank agrees to certain moratorium period and decrease in interest rate in initial periods. The present value of cash flows as per these revised terms calculated using original EIR is ₹ 25 crores. The fair value of the cash flows as per these revised terms is ₹ 28 crores.

Fair value of the consideration paid is ₹ 56 crores (70% of ₹ 80 crores) plus ₹ 28 crores i.e. ₹ 84 crores.

Accordingly, 2/3rd of the original financial liability is extinguished through issue of equity shares and terms of 1/3rd of the original financial liability have been modified. JK Ltd. will need to evaluate if this modification tantamount to "substantial modification" or not.

Applying the guidance contained in Appendix D to Ind AS 109:

- Difference between the fair value of equity instruments (₹ 56 crores) and 2/3rd of the original financial liability (2/3rd of ₹ 90 crores = ₹ 60 crores) i.e. ₹ 4 crores will be recognised as a gain in the statement of profit or loss
- Carrying amount of original financial liability which is not extinguished (1/3rd of ₹ 90 crores = ₹ 30 crores) is compared with the present value of cash flows as per these revised terms (₹ 25 crores)
- As the difference is more than 10%, this results in substantial modification of the original financial liability. Resultantly, the existing financial liability (₹ 30 crores) will be extinguished and the new financial liability will be recognised at its fair value i.e. ₹ 28 crores.
- The difference i.e. ₹ 2 crores will be recognised as a gain in the statement of profit or loss.

UNIT 5: DERIVATIVES AND EMBEDDED DERIVATIVES

5.1 INTRODUCTION

Derivatives may exist as standalone financial instruments or may be embedded in other financial or non-financial instruments.

In Unit 2 of this chapter, we analysed the definitions of financial liability and equity. Both these definitions envisage situations in which an instrument is settled by exchange of own equity instruments which are derivatives. To be specific, let's reproduce the relevant portion of these definitions and set the context of discussion for this paragraph in terms of this situation.

Financial liability

A financial instrument that fulfils **either** of (A) or (B) below:

(A) .....

(B) An instrument that will or may be settled in the entity's own equity instruments and is:

(i) .....

(ii) **a derivative** that will or may be settled **other than by** the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

Equity

A financial instrument that fulfils both (A) and (B) below:

(A) .....

(B) An instrument that will or may be settled in the entity's own equity instruments and is:

(i) .....

(ii) **a derivative** that will or may be settled **only by** the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

5.2 DEFINITION

5.2.1 Derivatives

Ind AS 109.Appendix A defines a derivative as a financial instrument or other contract with all of the following three characteristics:

i. **Value changes due to an underlying**: its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided **in the case of a non-financial variable that the variable is not specific to a party to the contract** (sometimes called the 'underlying');

Examples of common derivative contracts and the identified underlying variable:

Type of contract	Main pricing-settlement variable (underlying variable)
Interest rate swap	Interest rates
Currency swap (foreign exchange swap)	Currency rates
Commodity swap	Commodity prices
Equity swap	Equity prices (equity of another entity)
Credit swap	Credit rating, credit index or credit price
Total return swap	Total fair value of the reference asset and interest rates
Purchased or written treasury bond option (call or put)	Interest rates
Purchased or written currency option (call or put)	Currency rates
Purchased or written commodity option (call or put)	Commodity prices
Purchased or written stock option (call or put)	Equity prices (equity of another entity)
Interest rate futures linked to government debt (treasury futures)	Interest rates
Currency futures	Currency rates
Commodity futures	Commodity prices
Interest rate forward linked to government debt (treasury forward)	Interest rates
Currency forward	Currency rates
Commodity forward	Commodity prices
Equity forward	Equity prices (equity of another entity)

The definition of derivative excludes contracts which fulfil following two conditions:

- Value of the contract changes with reference to one or more non-financial variables; and
- That non-financial variable is specific to one of the parties to the contract.

As per paragraph BA.5 of Ind AS 109, a change in the fair value of a non-financial asset is specific to the owner if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific non-financial asset held (a non-financial variable).

Examples of non-financial variables that are not specific to a party to the contract are an index of earthquake losses in a particular region and an index of temperatures in a particular city.

Non-financial variables specific to a party to the contract include:

- the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract
- residual value of an asset which changes in response to changes in the asset's physical condition

Derivatives give one party a contractual right to exchange financial assets or financial liabilities with another party under conditions that are potentially favourable, or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavourable. Because the terms of the exchange are determined at inception, as prices in the financial markets change, those terms may become favourable or unfavourable.

A derivative usually has a notional amount, which can be an amount of currency, a number of shares, a number of units of weight or volume or other units specified in the contract. The changes in value of a derivative are measured corresponding to the notional amount. Refer illustration 1 and 2 below.

ii. **No or little initial net investment**: it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

Illustration 1: Prepaid interest rate swap (fixed rate payment obligation prepaid at inception)

Entity S enters into a ₹ 100 crores notional amount five-year pay-fixed, receive-variable interest rate swap with Counterparty C.

- *The interest rate of the variable part of the swap is reset on a quarterly basis to three-month Mumbai Interbank Offer Rate (MIBOR).*
- *The interest rate of the fixed part of the swap is 10% p.a.*
- *Entity S prepays its fixed obligation under the swap of ₹ 50 crores (₹ 100 crores × 10% × 5 years) at inception, discounted using market interest rates*
- *Entity S retains the right to receive interest payments on the ₹ 100 crores reset quarterly based on three-month MIBOR over the life of the swap.*

Analyse.

Solution

The initial net investment in the interest rate swap is significantly less than the notional amount on which the variable payments under the variable leg will be calculated. The contract requires an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, such as a variable rate bond.

Therefore, the contract fulfils the condition 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors'.

Even though Entity S has no future performance obligation, the ultimate settlement of the contract is at a future date and the value of the contract changes in response to changes in the LIBOR index. Accordingly, the contract is regarded as a derivative contract.

*****

Illustration 2: Prepaid pay-variable, receive-fixed interest rate swap

- *Entity S enters into a ₹ 100 crores notional amount five-year pay-variable, receive-fixed interest rate swap with Counterparty C.*
- *The variable leg of the swap is reset on a quarterly basis to three-month MIBOR.*
- *The fixed interest payments under the swap are calculated as 10% of the swap's notional amount, i.e. ₹ 10 crores p.a.*
- *Entity S prepays its obligation under the variable leg of the swap at inception at current market rates. Say, that amount is ₹ 36 crores.*
- *It retains the right to receive fixed interest payments of 10% on ₹ 100 crores every year.*

Analyse.

Solution

In effect, this contract results in an initial net investment of ₹ 36 crores which yields a cash inflow of ₹ 10 crores every year, for five years. By discharging the obligation to pay variable interest rate payments, Entity S in effect provides a loan to Counterparty C.

Therefore, all else being equal, the initial investment in the contract should equal that of other financial instruments that consist of fixed annuities. Thus, the initial net investment in the pay-variable, receive-fixed interest rate swap is equal to the investment required in a non-derivative contract that has a similar response to changes in market conditions.

For this reason, the instrument fails the condition 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors'. Therefore, the contract is not accounted for as a derivative contract.

*****

Illustration 3: Prepaid forward

Entity XYZ enters into a forward contract to purchase 1 million ordinary shares of Entity T in one year

- *The current market price of T is ₹ 50 per share*
- *The one-year forward price of T is ₹ 55 per share*
- *XYZ is required to prepay the forward contract at inception with a ₹ 50 million payment.*

Analyse.

Solution

Purchase of 1 million shares for current market price is likely to have the same response to changes in market factors as the contract mentioned above. Accordingly, the prepaid forward contract does not meet the initial net investment criterion of a derivative instrument.

*****

iii. **Future settlement**: it is settled at a future date.

However, it is not relevant whether the derivative is settled gross or not. For example, an interest rate swap is a derivative instrument, whether the counterparties pay interest to each other or settle it on a net basis.

Further, an option, say a call option i.e. a right to purchase shares at a fixed price at a certain date in future, may expire unexercised at maturity because it is 'out of money'. Such a contract is still a derivative contract because expiry at maturity is also a form of settlement even though there is no exchange of consideration eventually.

5.2.2 Embedded derivatives

Paragraph 4.3.1 of Ind AS 109 defines an embedded derivative as:

"An embedded derivative is:

- a **component** of a hybrid contract
- that also includes a **non-derivative host**
- with the effect that **some** of the **cash flows** of the combined instrument **vary** in a way **similar to a stand-alone derivative**.

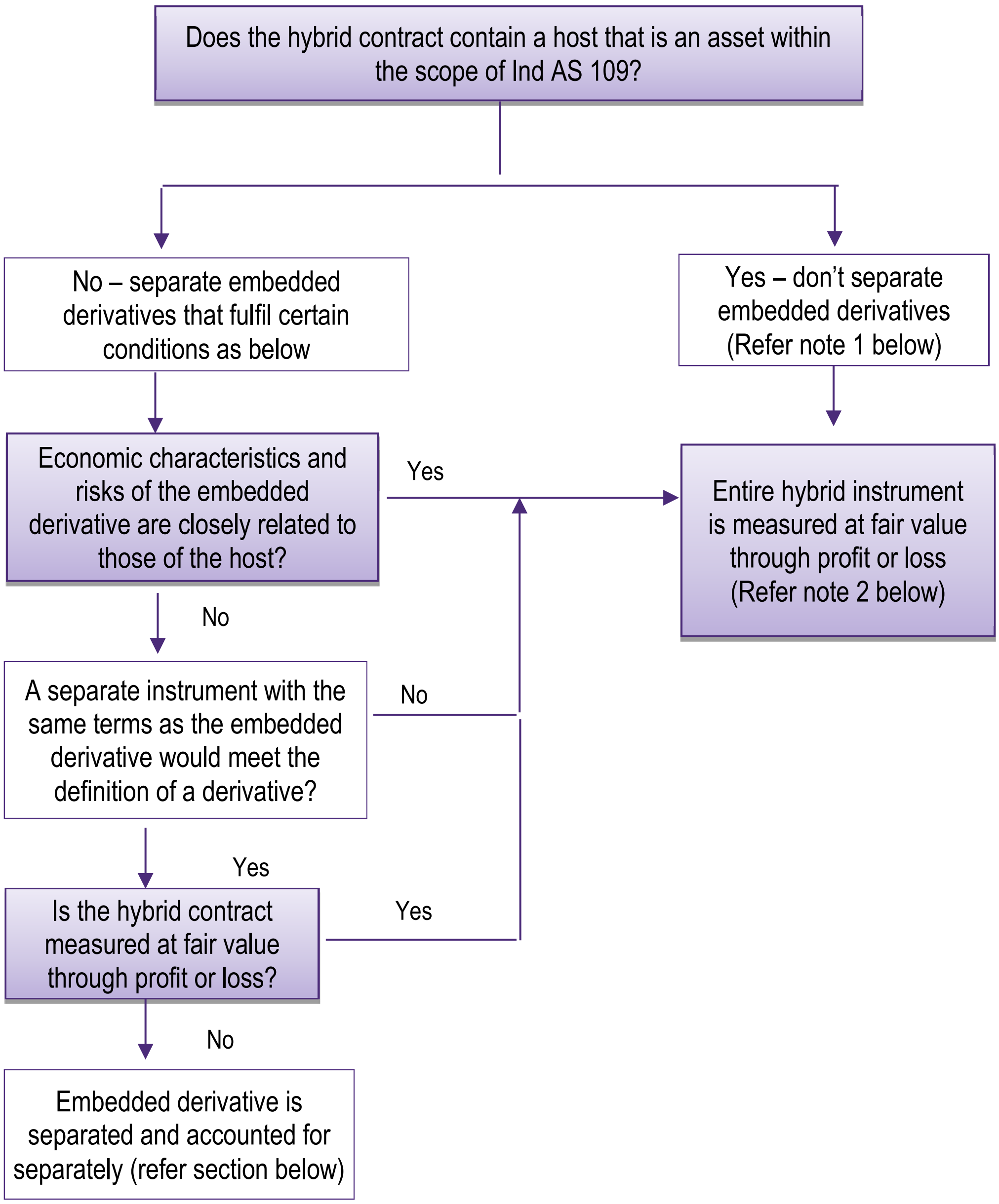
An embedded derivative **causes**:

- some or all of the **cash flows** that otherwise would be **required by the contract**
- to be **modified** according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable,
- provided **in the case of a non-financial variable** that the **variable is not specific to a party** to the contract.

A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty, is not an embedded derivative, but a separate financial instrument."

5.2.2.1Separation of embedded derivatives from host contract

In certain circumstances, an embedded derivative is required to be separated from the host contract and accounted for separately as a financial instrument. The flowchart below analyses those circumstances:



Note 1: This implies that embedded derivatives are permitted to be separated from only such hybrid contracts that contain a host which is either a (a) financial instrument classified as financial liability or equity or compound; or (b) contract for purchase or sale of a non-financial item.

Note 2: If both the host and embedded derivative have economic characteristics of an equity instrument, the hybrid instrument is not carried at fair value through profit or loss. In other words, this measurement category is applicable only for host contracts which are financial liabilities.

5.2.2.2 Economic characteristics and risks of the embedded derivative – whether closely related to those of the host?

Paragraphs B4.3.5 and B4.3.8 of Ind AS 109 provide examples of situations in which economic characteristics of the embedded derivative are considered to be closely related or not closely related to those of the host.

Some of these examples are explained below, though students are advised to understand all the examples given in the application guidance of the standards.

1. Underlying indices

Illustration 4: Debt instrument with indexed repayments

Entity X issues a redeemable fixed interest rate debenture to Entity Y. Amount of interest and principal is indexed to the value of equity instruments of Entity X

Analyse

Solution

In the given case, the host is a fixed interest rate debt instrument. The economic characteristics and risks of a debt instrument are not closely related to those of an equity instrument.

Hence, the exposure of this hybrid instrument to changes in value of equity instruments is an embedded derivative which is required to be separated.

The response above will not change even if the interest payment and principal repayments are indexed to a commodity index or similar underlying.

*****

2. Prepayment options in debt instruments

It is very common to have debt prepayment options in ordinary borrowing arrangements. Paragraph B4.3.5(e) of Ind AS 109 provides the guidance in this respect:

"A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless:

i. the option's exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument or the carrying amount of the host insurance contract;

or

ii. the exercise price of a prepayment option reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract. Lost interest is the product of the principal amount prepaid multiplied by the interest rate differential. The interest rate differential is the excess of the effective interest rate of the host contract over the effective interest rate the entity would receive at the prepayment date if it reinvested the principal amount prepaid in a similar contract for the remaining term of the host contract.

The assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element of a convertible debt instrument in accordance with Ind AS 32."

Ind AS 109 does not interpret the term "approximately equal". Management of entities will need to adopt a consistent accounting policy to apply this principle in general.

Illustration 5: Debt instrument with prepayment option

Entity PQR borrows ₹ 100 crores from CFDH Bank on 1 April 20X1.

Interest is payable at 12% p.a. and there is a bullet repayment of principal at the end of the term.

Term of the loan is 6 years.

The loan includes an option to prepay the loan at 1st April each year with a prepayment penalty of 3%.

There are no transaction costs.

Without the prepayment option, the interest rate quoted by bank is 11% p.a.

Analyse

Solution

Step 1: Identify the host contract and embedded derivative, if any

In the given case,

- Host is a debt instrument comprising annual interest payment at 12% p.a. and bullet principal repayment at the end of 6 years.
- Option to prepay the debt at ₹ 103 crores is an embedded derivative

Step 2: Determine the amortised cost of the host debt instrument

Whether the prepayment option is likely to be exercised or not, the amortised cost of the host debt instrument should be calculated as present value (PV) of expected cash flows using a fair market interest rate for a debt without the prepayment option (11% p.a. in this case). This is calculated below as ₹ 104.23 crores:

Year	Cash outflow	PV @ 11% p.a.	Finance cost	Amortised cost
	₹ crores			
1	12.00	10.81	11.46	103.68
2	12.00	9.74	11.41	103.09
3	12.00	8.77	11.34	102.43
4	12.00	7.90	11.27	101.70
5	12.00	7.12	11.20	100.90
6	112.00	59.88	11.10	-
		104.22	**67.78**	

Step 3: Compare the exercise price of the prepayment option with the amortised cost of the host debt instrument

Year	Amortised cost	Exercise price of prepayment option	Difference
	₹ Crores		
1	103.68	103.00	0.7%
2	103.09	103.00	0.1%
3	102.43	103.00	-0.6%
4	101.70	103.00	-1.3%
5	100.90	103.00	-2.1%
6	-	N/A	

The management of Entity PQR may formulate an appropriate accounting policy to determine what constitutes "approximately equal". In this case, if the management determines that a difference of more than 2% will indicate that the option's exercise price is not approximately equal to the amortised cost of the host debt instrument, it will need to separate the embedded derivative and account for it as per principles given in the subsequent sub-section.

It may be questioned as to why an option to repay a fixed rate loan early meets the definition of embedded derivative. Let us revisit an important phrase from the definition of embedded derivative:

"…some or all of the cash flows that otherwise would be required by the contract to be modified…"

In the context of a fixed rate debt, it may be interpreted that:

- the option affects cash flows only if exercised; and
- the cash flows of a fixed rate debt do not vary with interest rates.

However, in this context, a variation in cash flows should be interpreted as a possible change in the fair value of expected cash flows. Accordingly, the option's expected cash flows vary according to interest rates in a similar way as a separate option to purchase a fixed rate debt asset at a fixed price. A fixed price option to prepay a fixed rate loan will increase in value as interest rates decline (and vice versa).

*****

3. Foreign currency derivative embedded in contract for purchase or sale of non-financial items

Another common situation in trade and commerce in today's world is a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency. Paragraph B4.3.8(d) provides following guidance in this respect.

"An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

i. the functional currency of any substantial party to that contract;

ii. the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or

iii. a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade)."

The functional currencies of the parties should be determined in accordance with the definition and guidance in Ind AS 21.9 to 13.

Unless the above exceptions apply, the embedded foreign currency derivative should be separated from the host contract. Certain guidance on how to carry out the separation are enumerated below in detail:

1. the host contract is a sale or purchase contract denominated in the functional currency of the reporting entity

2. the amount of functional currency is determined using the relevant forward exchange rate (to the date of delivery) at the date the contract is entered into

3. the embedded derivative is a forward currency contract to buy or sell the applicable amount of the contract currency for the functional currency, at the same forward exchange rate. The effect is that the fair value of the embedded derivative is initially zero

4. subsequent changes in the fair value of the embedded derivative are recorded in profit or loss

5. on delivery of the non-financial item, the host contract is fulfilled and the embedded derivative is effectively settled. A foreign currency debtor or creditor is recognised for the contract amount, translated at the spot rate in accordance with Ind AS 21.23(a). The closing carrying amount of the embedded derivative is added to the functional currency amount of the host contract to give the initial carrying amount of the debtor or creditor.

Illustration 6: Purchase contract settled in a foreign currency

On 1 January 20X1, ABG Pvt. Ltd., a company incorporated in India enters into a contract to buy solar panels from A&A Associates, a firm domiciled in UAE, for which delivery is due after 6 months i.e. on 30 June 20X1

The purchase price for solar panels is US$ 50 million.

The functional currency of ABG is Indian Rupees (INR) and of A&A is Dirhams.

The obligation to settle the contract in US Dollars has been evaluated to be an embedded derivative which is not closely related to the host purchase contract.

Exchange rates:

1. *Spot rate on 1 January 20X1: USD 1 = INR 60*
2. *Six-month forward rate on 1 January 20X1: USD 1 = INR 65*
3. *Spot rate on 30 June 20X1: USD 1 = INR 66*

Analyse

Solution

This contract comprises of two components:

- Host contract to purchase solar panels denominated in INR i.e. a notional payment in INR at 6-month forward rate (INR 3,250 million or INR 325 crores)
- Forward contract to pay US Dollars and receive INR i.e. a notional receipt in INR. In other words, a forward contract to sell US Dollars at INR 65 per US Dollar

It may be noted that the notional INR payment in respect of host contract and the notional INR receipt in respect of embedded derivative create an offsetting position.

Subsequently, the host contract is not accounted for until delivery. The embedded derivative is recorded at fair value through profit or loss. This gives rise to a gain or loss on the derivative, and a corresponding derivative asset or liability.

On delivery ABG records the inventory at the amount of the host contract (INR 325 crores). The embedded derivative is considered to expire. The derivative asset or liability (i.e. the cumulative gain or loss) is settled by becoming part of the financial liability that arises on delivery.

In this case the carrying value of the currency forward at 30 June 20X1 on maturity is INR 50 million X (66 minus 65) = INR 5 crores (liability/loss). The loss arises because ABG has agreed to sell US Dollars at ₹ 65 per US Dollar whereas in the open market, US Dollar can be sold at ₹ 66 per US Dollar.

No accounting entries are passed on the date of entering into purchase contract. On that date, the forward contract has a fair value of zero (refer section "option and non-option based derivatives" below)

Subsequently, say at 30 June 20X1, the accounting entries are as follows (all in INR crores):

1.	Loss on derivative contract	5	
	To Derivative liability		5
	(Being loss on currency forward)		
2.	Inventory	325	
	To Trade payables (financial liability)		325
	(Being inventory recorded at forward exchange rate determined on date of contract)		
3.	Derivative liability	5	
	To Trade payables (financial liability)		5
	(Being reclassification of derivative liability to trade payables upon settlement)		

The effect is that the financial liability at the date of delivery is INR 330 crores (= INR 325 crores + INR 5 crores), equivalent to US$ 50 million at the spot rate on 30 June 20X1.

Going forward, the financial liability is a US$ denominated financial instrument. It is retranslated at the dollar spot rate in the normal way, until it is settled.

*****

4. Option and non-option based derivatives

A. Non-option based derivatives

The terms of an embedded non-option derivative, such as a forward or swap, must be determined so as to result in the embedded derivative having a fair value of zero at the inception of the hybrid contract. Non-option based derivatives represent obligations of the counterparties to a contract.

Fair value of a financial instrument is a combination of its intrinsic value and time value. In a fair and perfect market, it would be inappropriate to conclude that immediately at the inception of a contract, it results in creation of rights and obligations for two independent parties i.e. the contract has no intrinsic value at inception. Also, the time value starts accumulating only after the first day of the contract.

The standard specifies that if it were permitted to separate embedded non-option derivatives on other terms, a single hybrid contract could be decomposed into an infinite variety of combinations of host debt instruments and embedded derivatives, for example, by separating embedded derivatives with terms that create leverage, asymmetry or some other risk exposure not already present in the hybrid contract. Therefore, it is inappropriate to separate an embedded non-option derivative on terms that result in a fair value other than zero at the inception of the hybrid contract.

Further, in the case of non-option based derivatives, terms of the host debt instrument reflect the (a) stated or (b) implied substantive terms of the hybrid contract. In the absence of implied or stated terms, the entity makes its own judgement of the terms.

B. Option based derivatives

The economic behaviour of a hybrid contract with an option-based embedded derivative depends critically on the strike price (or exercise price) specified for the option feature in the hybrid contract. Therefore, the separation of an option-based embedded derivative (including any embedded put, call, cap, floor, caption, floortion or swaption feature in a hybrid contract) should be based on the stated terms of the option feature documented in the hybrid contract (unlike a non-option based derivative which is separated on the basis of implied terms also). As a result, the embedded derivative would not necessarily have a fair value or intrinsic value equal to zero at the initial recognition of the hybrid contract.

If an entity were required to identify the terms of an embedded option-based derivative so as to achieve a fair value of the embedded derivative of zero, the strike price generally would have to be determined so as to result in the option being infinitely out of the money. This would imply a zero probability of the option feature being exercised. However, since the probability of the option feature in a hybrid contract being exercised generally is not zero, it would be inconsistent with the likely economic behaviour of the hybrid contract to assume an initial fair value of zero. Similarly, if an entity were required to identify the terms of an embedded option-based derivative so as to achieve an intrinsic value of zero for the embedded derivative, the strike price would have to be assumed to equal the price (or rate) of the underlying variable at the initial recognition of the hybrid contract. In this case, the fair value of the option would consist only of time value. However, such an assumption would not be consistent with the likely economic behaviour of the hybrid contract, including the probability of the option feature being exercised, unless the agreed strike price was indeed equal to the price of the underlying variable at the initial recognition of the hybrid contract.

The economic nature of an option-based embedded derivative is fundamentally different from a forward-based embedded derivative (including forwards and swaps), because the terms of a forward are such that a payment based on the difference between the price of the underlying and the forward price will occur at a specified date, while the terms of an option are such that a payment based on the difference between the price of the underlying and the strike price of the option may or may not occur depending on the relationship between the agreed strike price and the price of the underlying at a specified date or dates in the future. Adjusting the strike price of an option-based embedded derivative, therefore, alters the nature of the hybrid contract. On the other hand, if the terms of a non-option embedded derivative in a host debt instrument were determined so as to result in a fair value of any amount other than zero at the inception of the hybrid contract, that amount would essentially represent a borrowing or lending. Accordingly, it is not appropriate to separate a non-option embedded derivative in a host debt instrument on terms that result in a fair value other than zero at the initial recognition of the hybrid contract.

5.2.2.3 Accounting for embedded derivatives

If the flowchart given in paragraph "Separation of embedded derivatives" results in the conclusion that the embedded derivatives are required to be separated, an entity shall measure the derivatives at fair value at initial recognition and subsequently at fair value through profit or loss. *[Paragraph 4.3.4 of Ind AS 109]*

The initial carrying amount of the host instrument is the residual amount after separating the embedded derivative. *[Paragraph B4.3.3 of Ind AS 109]*

As per paragraph 4.3.5 of Ind AS 109, if a contract contains one or more embedded derivatives and the host is not a financial asset, an entity may designate the entire hybrid contract as at fair value through profit or loss unless:

i. the embedded derivative does not significantly modify the cash flows that otherwise would be required by the contract; or

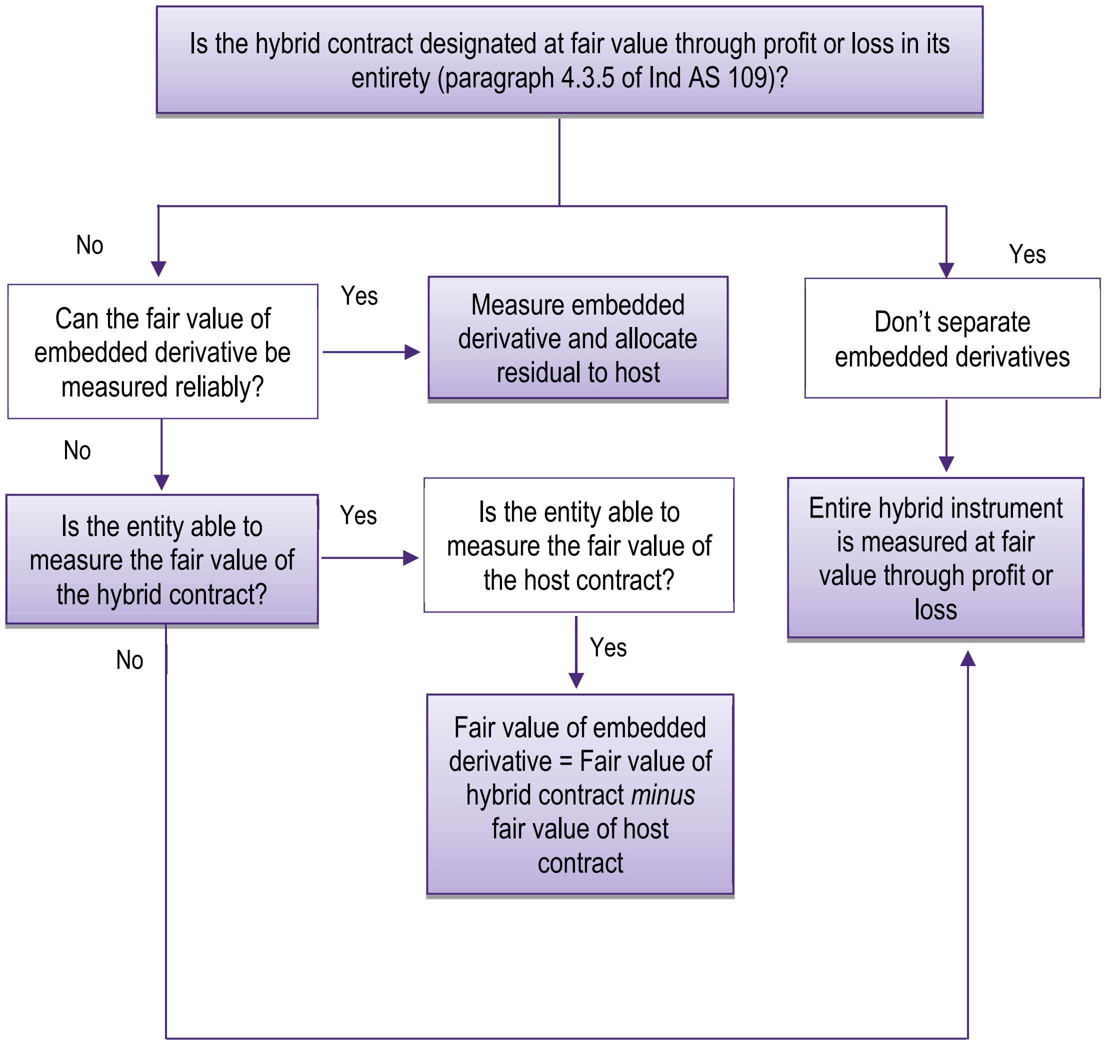
ii. it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

These are two exceptions to the general principle that hybrid contracts can be measured at fair value in their entirety, without separation of embedded derivatives. Refer explanation below Illustration 5 for interpretation of the phrase "significantly modify cash flows" mentioned above.

Further, as per paragraph 4.3.6 of Ind AS 109, if an entity is required to separate an embedded derivative from its host (as per flowchart presented earlier in this paragraph), but is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid contract as at fair value through profit or loss.

If an entity is unable to measure reliably the fair value of an embedded derivative on the basis of its terms and conditions, the fair value of the embedded derivative is the difference between the fair value of the hybrid contract and the fair value of the host. If the entity is unable to measure the fair value of the embedded derivative using this method, the hybrid contract is designated as at fair value through profit or loss.

To conclude, picking up from the flowchart presented earlier in this paragraph, the accounting implications are demonstrated in the flow chart below:


Is the hybrid contract designated at fair value through profit or loss in its entirety (paragraph 4.3.5 of Ind AS 109)?
No
Yes
Can the fair value of embedded derivative be measured reliably?
Yes
Measure embedded derivative and allocate residual to host
Don't separate embedded derivatives
No
Is the entity able to measure the fair value of the hybrid contract?
Yes
Is the entity able to measure the fair value of the host contract?
Entire hybrid instrument is measured at fair value through profit or loss
No
Yes
Fair value of embedded derivative = Fair value of hybrid contract *minus* fair value of host contract

UNIT 6: DISCLOSURES

6.1 INTRODUCTION

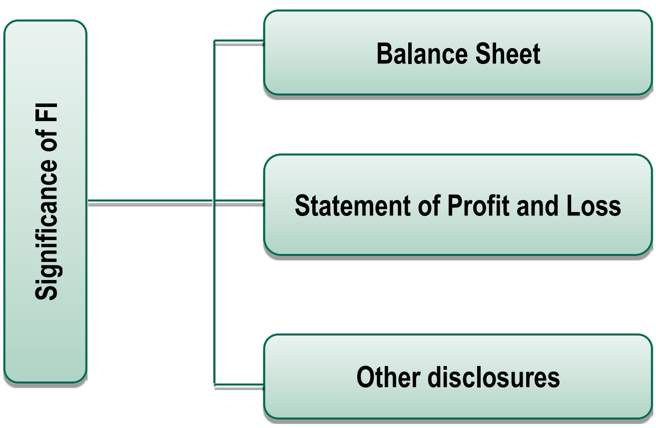
Ind AS 107 provides disclosures for financial instruments to be made in the financial statements that enable users to evaluate:

(a) The significance of financial instruments for the entity's financial position and performance; and

(b) The nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period; and how the entity manages those risks.

6.2 SIGNIFICANCE OF FINANCIAL INSTRUMENTS

An entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.



6.3 BALANCE SHEET

- **Categories of financial assets and financial liabilities**

  The carrying amounts of each of the following categories, as defined in Ind AS 109, shall be disclosed either in the statement of financial position or in the notes:

(a) Financial assets measured at fair value through profit or loss, showing separately

   i. those designated as such upon initial recognition or subsequently in accordance with Ind AS 109 (ie, financial asset whose credit risk exposure is managed through credit derivative that is measured at fair value through profit or loss and hence, such financial asset is also managed at fair value through profit or loss); and

   ii. those mandatorily measured at fair value through profit or loss in accordance with Ind AS 109.

(b) financial liabilities at fair value through profit or loss, showing separately –

   i. those designated as such upon initial recognition or subsequently in accordance with Ind AS 109 (ie, financial liability whose credit risk exposure is managed through credit derivative that is measured at fair value through profit or loss and hence, such financial liability is also managed at fair value through profit or loss; and

   ii. those that meet the definition of held for trading in Ind AS 109.

(c) financial assets measured at amortised cost.

(d) financial liabilities measured at amortised cost.

(e) financial assets measured at fair value through other comprehensive income, showing separately –

   i. financial assets that are measured at fair value through other comprehensive income in accordance with Ind AS 109;

   ii. investments in equity instruments designated as such upon initial recognition in accordance with Ind AS 109.

- **Financial assets or financial liabilities at fair value through profit or loss**

  ♦ If the entity has designated as measured at fair value through profit or loss a financial asset (or group of financial assets) that would otherwise be measured at fair value through other comprehensive income or amortised cost, it shall disclose:

   (a) the maximum exposure to credit risk of the financial asset (or group of financial assets) at the end of the reporting period.

   (b) the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk.

   (c) the amount of change, during the period and cumulatively, in the fair value of the financial asset (or group of financial assets) that is attributable to changes in the credit risk of the financial asset determined either:

i. as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or

ii. using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.

Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate or index of prices or rates.

(d) the amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the financial asset was designated.

- If the entity has designated a financial liability as at fair value through profit or loss in accordance with Ind AS 109 and is required to present the effects of changes in that liability's credit risk in other comprehensive income, it shall disclose:

(a) the amount of change, cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability

(b) the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

(c) any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers.

(d) if a liability is derecognised during the period, the amount (if any) presented in other comprehensive income that was realised at derecognition.

- If an entity has designated a financial liability as at fair value through profit or loss in accordance with Ind AS 109 and is required to present all changes in the fair value of that liability (including the effects of changes in the credit risk of the liability) in profit or loss, it shall disclose:

(a) Amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability;

and

(b) Difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

- **Investments in equity instruments designated at fair value through other comprehensive income**

  - ♦ If an entity has designated investments in equity instruments to be measured at fair value through other comprehensive income in accordance with Ind AS 109, it shall disclose:

    (a) which investments in equity instruments have been designated to be measured at fair value through other comprehensive income.

    (b) the reasons for using this presentation alternative.

    (c) the fair value of each such investment at the end of the reporting period.

    (d) dividends recognised during the period, showing separately those related to investments derecognised during the reporting period and those related to investments held at the end of the reporting period.

    (e) any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers.

  - ♦ If an entity derecognised investments in equity instruments measured at fair value through other comprehensive income during the reporting period, it shall disclose:

    (a) the reasons for disposing of the investments

    (b) the fair value of the investments at the date of derecognition

    (c) the cumulative gain or loss on disposal.

- **Reclassifications**

  - ♦ An entity shall disclose if, in the current or previous reporting periods, it has reclassified any financial assets in accordance with Ind AS 109. For each such event, an entity shall disclose –

    (a) the date of reclassification.

    (b) a detailed explanation of the change in business model and a qualitative description of its effect on the entity's financial statements.

    (c) the amount reclassified into and out of each category.

  - ♦ For each reporting period following reclassification until derecognition, an entity shall disclose for assets reclassified out of the fair value through profit or loss category so that they are measured at amortised cost or fair value through other comprehensive income in accordance with Ind AS 109:

    (a) the effective interest rate determined on the date of reclassification; and

    (b) the interest revenue recognised.

- If, since its last annual reporting date, an entity has reclassified financial assets out of the fair value through other comprehensive income category so that they are measured at amortised cost; or out of the fair value through profit or loss category so that they are measured at amortised cost or fair value through other comprehensive income it shall disclose:
  - (a) the fair value of the financial assets at the end of the reporting period; and
  - (b) the fair value gain or loss that would have been recognised in profit or loss or other comprehensive income during the reporting period if the financial assets had not been reclassified.

- **Off-setting financial assets and financial liabilities**
  - An entity shall disclose, at the end of the reporting period, the following quantitative information separately for recognised financial assets and recognised financial liabilities that have been off-set in accordance with Ind AS 32:
    - (a) the gross amounts of those recognised financial assets and recognised financial liabilities;
    - (b) the amounts that are set off in accordance with the criteria in Ind AS 32 when determining the net amounts presented in the statement of financial position;
    - (c) the net amounts presented in the statement of financial position;
    - (d) the amounts subject to an enforceable master netting arrangement or similar agreement that are not otherwise included in the information disclosed for amounts set off in paragraph (b) above, including:
      - i. amounts related to recognised financial instruments that do not meet some or all of the offsetting criteria in paragraph 42 of Ind AS 32; and
      - ii. amounts related to financial collateral (including cash collateral); and
    - (e) the net amount after deducting the amounts in (d) from the amounts in (c) above.

- Collateral
  - An entity shall disclose:
    - (a) the carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with Ind AS 109; and
    - (b) the terms and conditions relating to its pledge.
  - When an entity holds collateral (of financial or non-financial assets) and is permitted to sell or repledge the collateral in the absence of default by the owner of the collateral, it shall disclose:

(a) the fair value of the collateral held;

(b) the fair value of any such collateral sold or repledged, and whether the entity has an obligation to return it; and

(c) the terms and conditions associated with its use of the collateral.

- **Allowance for credit losses**

  The carrying amount of financial assets measured at fair value through other comprehensive income in accordance with Ind AS 109 is not reduced by a loss allowance and an entity shall not present the loss allowance separately in the statement of financial position as a reduction of the carrying amount of the financial asset. However, an entity shall disclose the loss allowance in the notes to the financial statements.

- **Compound financial instruments with multiple embedded derivatives**

  If an entity has issued an instrument that contains both a liability and an equity component and the instrument has multiple embedded derivatives whose values are interdependent (such as a callable convertible debt instrument), it shall disclose the existence of those features.

- **Defaults and breaches**

  ♦ For loans payable recognised at the end of the reporting period, an entity shall disclose:

  (a) details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable;

  (b) the carrying amount of the loans payable in default at the end of the reporting period; and

  (c) whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue.

  ♦ If, during the period, there were breaches of loan agreement terms other than those that are existing at the year end and covered by year-end disclosure above, an entity shall disclose the same information as required by paragraph above, if those breaches permitted the lender to demand accelerated repayment (unless the breaches were remedied, or the terms of the loan were renegotiated, on or before the end of the reporting period).

6.4 STATEMENT OF PROFIT AND LOSS

An entity shall disclose the following items of income, expense, gains or losses either in the statement of comprehensive income or in the notes:

(a) net gains or net losses on:

i. financial assets or financial liabilities measured at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition or subsequently in accordance with Ind AS 109, and those on financial assets or financial liabilities that are mandatorily measured at fair value through profit or loss in accordance with Ind AS 109 (eg financial liabilities that meet the definition of held for trading in Ind AS 109).

   For financial liabilities designated as at fair value through profit or loss, an entity shall show separately the amount of gain or loss recognised in other comprehensive income and the amount recognised in profit or loss.

ii. financial liabilities measured at amortised cost

iii. financial assets measured at amortised cost

iv. investments in equity instruments designated at fair value through other comprehensive income in accordance with Ind AS109

v. financial assets measured at fair value through other comprehensive income in accordance with Ind AS 109, showing separately the amount of gain or loss recognised in other comprehensive income during the period and the amount reclassified upon derecognition from accumulated other comprehensive income to profit or loss for the period.

(b) total interest revenue and total interest expense (calculated using the effective interest method) for financial assets that are measured at amortised cost or that are measured at fair value through other comprehensive income (showing these amounts separately); or financial liabilities that are not measured at fair value through profit or loss

(c) fee income and expense (other than amounts included in determining the effective interest rate) arising from:

i. financial assets and financial liabilities that are not at fair value through profit or loss; and

ii. trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions.

6.5 OTHER DISCLOSURES

- **Accounting policies**

  An entity discloses its significant accounting policies comprising the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.

- **Hedge accounting**

  An entity shall apply these disclosure requirements for those risk exposures that an entity hedges and for which it elects to apply hedge accounting. Hedge accounting disclosures shall provide information about:

  (a) an entity's risk management strategy and how it is applied to manage risk;

  (b) how the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows; and

  (c) the effect that hedge accounting has had on the entity's statement of financial position, statement of comprehensive income and statement of changes in equity.

- **Fair value**

  ♦ For each class of financial assets and financial liabilities (see paragraph 6), an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount. In disclosing fair values, an entity shall group financial assets and financial liabilities into classes, but shall offset them only to the extent that their carrying amounts are offset in the statement of financial position.

  ♦ In some cases, an entity does not recognise a gain or loss on initial recognition of a financial asset or financial liability because the fair value is neither evidenced by a quoted price in an active market for an identical asset or liability (ie a Level 1 input) nor based on a valuation technique that uses only data from observable markets. In such cases, the entity shall disclose by class of financial asset or financial liability:

  (a) its accounting policy for recognising in profit or loss the difference between the fair value at initial recognition and the transaction price to reflect a change in factors (including time) that market participants would take into account when pricing the asset or liability

  (b) aggregate difference yet to be recognised in profit or loss at the beginning and end of the period and a reconciliation of changes in the balance of this difference.

  (c) why the entity concluded that the transaction price was not the best evidence of fair value, including a description of the evidence that supports the fair value.

  ♦ Disclosures of fair value are not required:

  (a) when the carrying amount is a reasonable approximation of fair value, for example, for financial instruments such as short-term trade receivables and payables;

  (b) for a contract containing a discretionary participation feature (as described in Ind AS 104) if the fair value of that feature cannot be measured reliably; or

  (c) for lease liabilities.

- In case of contracts with discretionary participation feature, where fair value cannot be determined reliably, an entity shall disclose information to help users of the financial statements make their own judgements about the extent of possible differences between the carrying amount of those contracts and their fair value, including:

  (a) the fact that fair value information has not been disclosed for these instruments because their fair value cannot be measured reliably;

  (b) a description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be measured reliably;

  (c) information about the market for the instruments;

  (d) information about whether and how the entity intends to dispose of the financial instruments; and

  (e) if financial instruments whose fair value previously could not be reliably measured are derecognised, that fact, their carrying amount at the time of derecognition, and the amount of gain or loss recognised.

- **Nature and extent of risks arising from financial instruments**

  - An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.

  - The disclosures described below focus on the risks that arise from financial instruments and how they have been managed. These risks typically include, but are not limited to, **credit risk, liquidity risk and market risk**.

  - **Qualitative disclosures**

    For each type of risk arising from financial instruments, an entity shall disclose:

    (a) the exposures to risk and how they arise;

    (b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and

    (c) any changes in (a) or (b) from the previous period.

  - **Quantitative disclosures –**

    For each type of risk arising from financial instruments, including – credit risk, liquidity risk and market risk, an entity shall disclose:

    (a) summary quantitative data about its exposure to that risk at the end of the reporting period. This disclosure shall be based on the information provided internally to key management personnel of the entity, for example the entity's board of directors or chief executive officer

(b) certain detailed disclosures required for each type of risk mentioned above, to the extent not provided in accordance with (a).

(c) concentration of risk if not apparent from the disclosures made in accordance with (a) and (b).

If the quantitative data disclosed as at the end of the reporting period are unrepresentative of an entity's exposure to risk during the period, an entity shall provide further information that is representative.

- **Credit risk:**

An entity shall apply the disclosure requirements in paragraphs 35F–35N of Ind AS 107 (as described below) to financial instruments to which the impairment requirements in Ind AS 109 are applied. However:

(a) For trade receivables, contract assets and lease receivables, paragraph 35J(a) applies to those trade receivables, contract assets or lease receivables on which lifetime expected credit losses are recognised in accordance with Ind AS 109, if those financial assets are modified while more than 30 days past due; and

(b) paragraph 35K(b) does not apply to lease receivables.

- The credit risk disclosures described below shall enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows. To achieve this objective, credit risk disclosures shall provide:

(a) information about an entity's credit risk management practices and how they relate to the recognition and measurement of expected credit losses, including the methods, assumptions and information used to measure expected credit losses

(b) quantitative and qualitative information that allows users of financial statements to evaluate the amounts in the financial statements arising from expected credit losses, including changes in the amount of expected credit losses and the reasons for those changes; an

(c) information about an entity's credit risk exposure (ie the credit risk inherent in an entity's financial assets and commitments to extend credit) including significant credit risk concentrations.

- **The credit risk management practices**

An entity shall explain its credit risk management practices and how they relate to the recognition and measurement of expected credit losses. To meet this objective an entity shall disclose information that enables users of financial statements to understand and evaluate:

(a) how an entity determined whether the credit risk of financial instruments has increased significantly since initial recognition, including, if and how:

i. financial instruments are considered to have low credit risk in accordance with Ind AS 109, including the classes of financial instruments to which it applies; and

ii. the presumption of Ind AS 109, that there have been significant increases in credit risk since initial recognition when financial assets are more than 30 days past due, has been rebutted;

(b) an entity's definitions of default, including the reasons for selecting those definitions;

(c) how the instruments were grouped if expected credit losses were measured on a collective basis;

(d) how an entity determined that financial assets are credit-impaired financial assets;

(e) an entity's write-off policy, including the indicators that there is no reasonable expectation of recovery and information about the policy for financial assets that are written-off but are still subject to enforcement activity; and

(f) how the requirements in Ind AS 109 for the modification of contractual cash flows of financial assets have been applied, including how an entity:

i. determines whether the credit risk on a financial asset that has been modified while the loss allowance was measured at an amount equal to lifetime expected credit losses, has improved to the extent that the loss allowance reverts to being measured at an amount equal to 12-month expected credit losses in accordance with Ind AS 109; and

ii. monitors the extent to which the loss allowance on financial assets meeting the criteria in (i) is subsequently remeasured at an amount equal to lifetime expected credit losses in accordance with Ind AS 109.

♦ An entity shall explain the inputs, assumptions and estimation techniques used to apply the impairment requirements in Ind AS 109. For this purpose, an entity shall disclose:

(a) the basis of inputs and assumptions and the estimation techniques used to:

i. measure the 12-month and lifetime expected credit losses;

ii. determine whether the credit risk of financial instruments has increased significantly since initial recognition; and

iii. determine whether a financial asset is a credit-impaired financial asset.

(b) how forward-looking information has been incorporated into the determination of expected credit losses, including the use of macroeconomic information; and

(c) changes in the estimation techniques or significant assumptions made during the reporting period and the reasons for those changes.

- Quantitative and qualitative information about amounts arising from expected credit losses

  To explain the changes in the loss allowance and the reasons for those changes, an entity shall provide, by class of financial instrument, a reconciliation from the opening balance to the closing balance of the loss allowance, in a table, showing separately the changes during the period for:

  (a) the loss allowance measured at an amount equal to 12-month expected credit losses;

  (b) the loss allowance measured at an amount equal to lifetime expected credit losses for:

     i. financial instruments for which credit risk has increased significantly since initial recognition but that are not credit-impaired financial assets;

     ii. financial assets that are credit-impaired at the reporting date (but that are not purchased or originated credit-impaired); and

     iii. trade receivables, contract assets or lease receivables for which the loss allowances are measured in accordance with Ind AS 109

  (c) financial assets that are purchased or originated credit-impaired. In addition to the reconciliation, an entity shall disclose the total amount of undiscounted expected credit losses at initial recognition on financial assets initially recognised during the reporting period.

- **Credit risk exposure**

  To enable users of financial statements to assess an entity's credit risk exposure and understand its significant credit risk concentrations, an entity shall disclose, by credit risk rating grades, the gross carrying amount of financial assets and the exposure to credit risk on loan commitments and financial guarantee contracts. This information shall be provided separately for financial instruments:

  (a) for which the loss allowance is measured at an amount equal to 12-month expected credit losses;

(b) for which the loss allowance is measured at an amount equal to lifetime expected credit losses and that are:

i. financial instruments for which credit risk has increased significantly since initial recognition but that are not credit-impaired financial assets;

ii. financial assets that are credit-impaired at the reporting date (but that are not purchased or originated credit-impaired); and

iii. trade receivables, contract assets or lease receivables for which the loss allowances are measured at life-time expected credit losses as an option provided in Ind AS 109.

- For all financial instruments to which the impairment requirements in Ind AS 109 are not applied, an entity shall disclose by class of financial instrument:

  (a) the amount that best represents its maximum exposure to credit risk at the end of the reporting period without taking account of any collateral held or other credit enhancements (eg netting agreements that do not quality for offset in accordance with Ind AS 32); this disclosure is not required for financial instruments whose carrying amount best represents the maximum exposure to credit risk.

  (b) a description of collateral held as security and other credit enhancements, and their financial effect (eg quantification of the extent to which collateral and other credit enhancements mitigate credit risk) in respect of the amount that best represents the maximum exposure to credit risk (whether disclosed in accordance with (a) or represented by the carrying amount of a financial instrument).

- **Liquidity risk**

  An entity shall disclose:

  (a) a maturity analysis for non-derivative financial liabilities (including issued financial guarantee contracts) that shows the remaining contractual maturities.

  (b) a maturity analysis for derivative financial liabilities.

  The maturity analysis shall include the remaining contractual maturities for those derivative financial liabilities for which contractual maturities are essential for an understanding of the timing of the cash flows.

  (c) a description of how it manages the liquidity risk inherent in (a) and (b).

- **Market risk**

  - An entity shall disclose:

    (a) a sensitivity analysis for each type of market risk to which the entity is exposed at the end of the reporting period, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date;

(b) the methods and assumptions used in preparing the sensitivity analysis; and

(c) changes from the previous period in the methods and assumptions used, and the reasons for such changes.

- If an entity prepares a sensitivity analysis, such as value-at-risk, that reflects interdependencies between risk variables (eg interest rates and exchange rates) and uses it to manage financial risks, it may use that sensitivity analysis in place of the analysis specified in paragraph 40. The entity shall also disclose:

  (a) an explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided; and

  (b) an explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.

Note: Students are advised to read the application guidance to Ind AS 107 for better understanding of the disclosure requirements related to financial instruments.

UNIT 7: HEDGE ACCOUNTING

7.1 INTRODUCTION

The objective of hedge accounting is to **represent**, in the financial statements, **the effect of an entity's risk management activities that use financial instruments to manage exposures** arising from particular risks that could affect profit or loss (or other comprehensive income, in the case of investments in equity instruments for which an entity has elected to present changes in fair value in other comprehensive income).

An entity may choose to designate a hedging relationship between a hedging instrument and a hedged item, ie, hedge accounting is an option provided qualifying criteria are met. In such case, accounting for gain/ loss arising on the hedging relationship, ie, including hedging instrument and hedged item shall be accounted in a specific manner as detailed further in the unit in order to avoid measurement and recognition inconsistencies which may arise otherwise if the hedging instrument and hedged item were accounted separately.

A step wise analysis has been presented using the following diagrammatic presentation –

Step 1 →	Identify the hedged item [ie, exposed to one or more risks]
Step 2 →	Identify the hedging instrument [ie, a derivative or non-derivative to off-set risks in cash flow/ fair value of hedged item]
Step 3 →	Evaluate if hedging relationship meets the requisite criteria for hedge accounting
Step 4 →	If hedge is effective, establish type of hedge – (A) Fair value hedge (B) Cash flow hedge (C) Hedge of net investment in foreign operation
Step 6 →	Account for the hedging relationship basis guidance in Ind AS 109

A hedge relationship can be evaluated for a single hedged item or group of items and the hedging instrument can also be a single instrument or multiple instruments hedging specific risk associated with the hedged item.

7.2 IDENTIFYING THE HEDGED ITEM AND DESIGNATION OF HEDGED ITEMS

- A hedged item can be a recognised **asset** or **liability**, an unrecognised **firm commitment**, a **forecast transaction** or a **net investment in a foreign operation**. The hedged item can be:

  (a) a single item; or

  (b) a group of items.

  A hedged item can also be a component of such an item or group of items.

- The hedged item must be reliably measurable.
- If a hedged item is a forecast transaction (or a component thereof), that transaction must be highly probable.
- An entity may designate an item in its **entirety or a component of an item** as the hedged item in a hedging relationship.
  - An entire item comprises all changes in cash flows or fair value of an item.
  - A component comprises less than the entire fair value change or cash flow variability of an item. In that case, an entity may designate only the following types of components (including combinations) as hedged items:

    (a) only changes in the cash flows or fair value of an item attributable to a specific risk or risks (risk component), provided that, based on an assessment within the context of the particular market structure, the risk component is separately identifiable and reliably measurable. Risk components include a designation of only changes in the cash flows or the fair value of a hedged item above or below a specified price or other variable (a one-sided risk).

    (b) one or more selected contractual cash flows.

    (c) components of a nominal amount, ie a specified part of the amount of an item

7.3 QUALIFYING INSTRUMENTS FOR HEDGE ACCOUNTING AND DESIGNATION OF HEDGING INSTRUMENTS

Hedging instrument → **Derivative measured at fair value through profit or loss (except for written options)**

Hedging instrument → **Non-Derivative financial asset or financial liability measured at fair value through profit or loss**

- **Exceptions to designating non-derivative financial asset or non-derivative financial liability as hedging instrument:**
  - ♦ A financial liability designated as at fair value through profit or loss for which the amount of its change in fair value that is attributable to changes in the credit risk of that liability is presented in other comprehensive income.
  - ♦ For a hedge of foreign currency risk, the foreign currency risk component of a non-derivative financial asset or a non-derivative financial liability may be designated as a hedging instrument provided that it is not an investment in an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income.
- For hedge accounting purposes, only contracts with a party external to the reporting entity (ie external to the group or individual entity that is being reported on) can be designated as hedging instruments.
- **A qualifying instrument must be designated in its entirety as a hedging instrument.** The only **exceptions permitted** are:

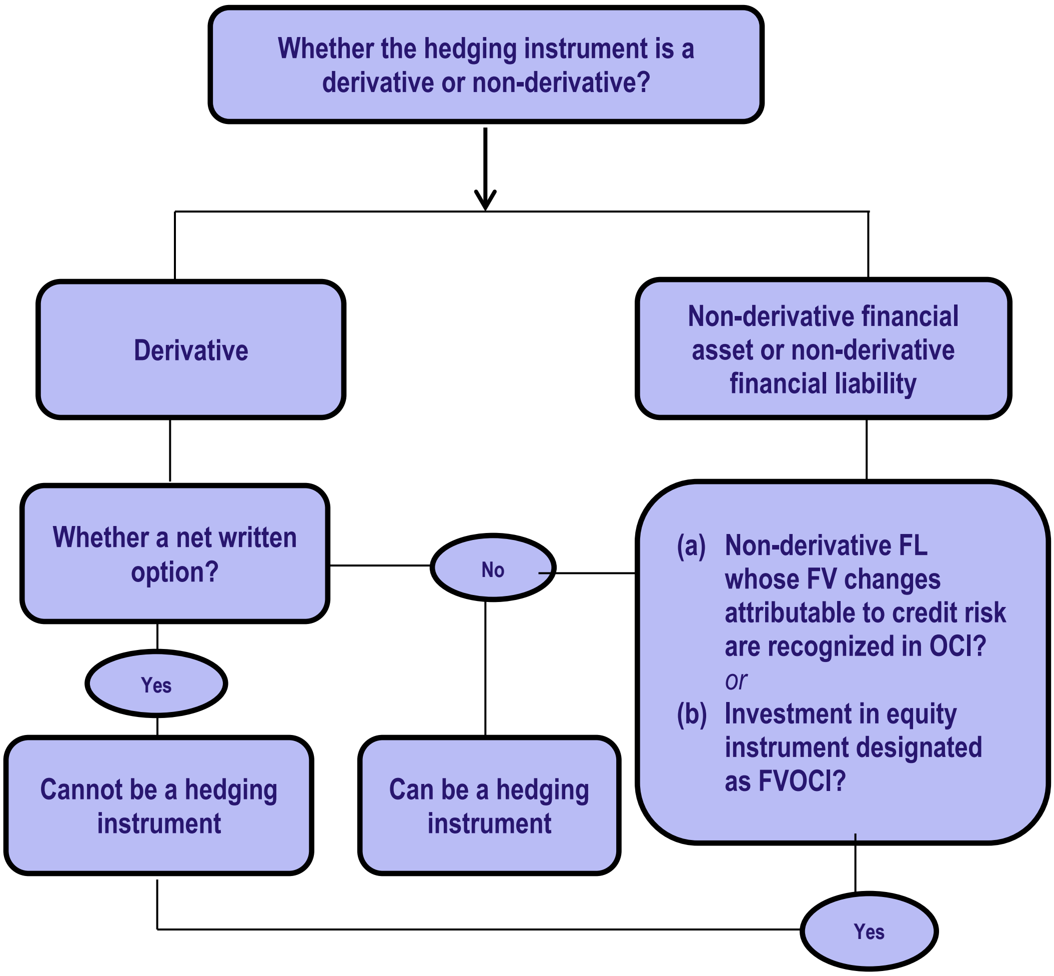
  (a) separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and not the change in its time value;

  (b) separating the forward element and the spot element of a forward contract and designating as the hedging instrument only the change in the value of the spot element of a forward contract and not the forward element; and

  (c) a proportion of the entire hedging instrument, such as 50 per cent of the nominal amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging instrument may not be designated for a part of its change in fair value that results from only a portion of the time period during which the hedging instrument remains outstanding.

- **Written options are not hedging instruments:** A derivative instrument that combines a written option and a purchased option (for example, an interest rate collar) does not qualify as a hedging instrument if it is, in effect, a net written option at the date of designation.

  The decision tree to determining if an instrument can be designated as a hedging instrument is as follows:



7.4 QUALIFYING CRITERIA FOR HEDGE ACCOUNTING

A hedging relationship qualifies for hedge accounting only if all of the following criteria are met:

(a) Hedging relationship consists only of **eligible hedging instruments and eligible hedged items**.

(b) At the inception of the hedging relationship, there is **formal designation and documentation of the hedging relationship** and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item, the nature of the risk being hedged and how the entity will assess whether the hedging relationship meets the hedge effectiveness requirements (including its analysis of the sources of hedge ineffectiveness and how it determines the hedge ratio)

(c) Hedging relationship **meets all** of the following **hedge effectiveness requirements**:

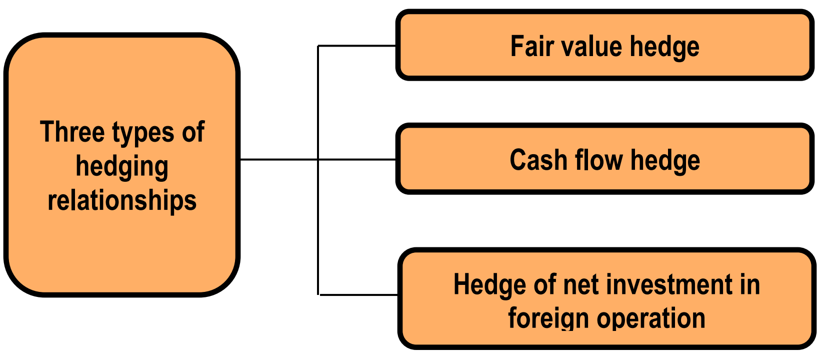
i. there is an **economic relationship** between the hedged item and the hedging instrument;

ii. the effect of **credit risk does not dominate** the value changes that result from that economic relationship; and

iii. the **hedge ratio** of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. However, that designation shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting.

7.5 ACCOUNTING FOR QUALIFYING HEDGING RELATIONSHIPS

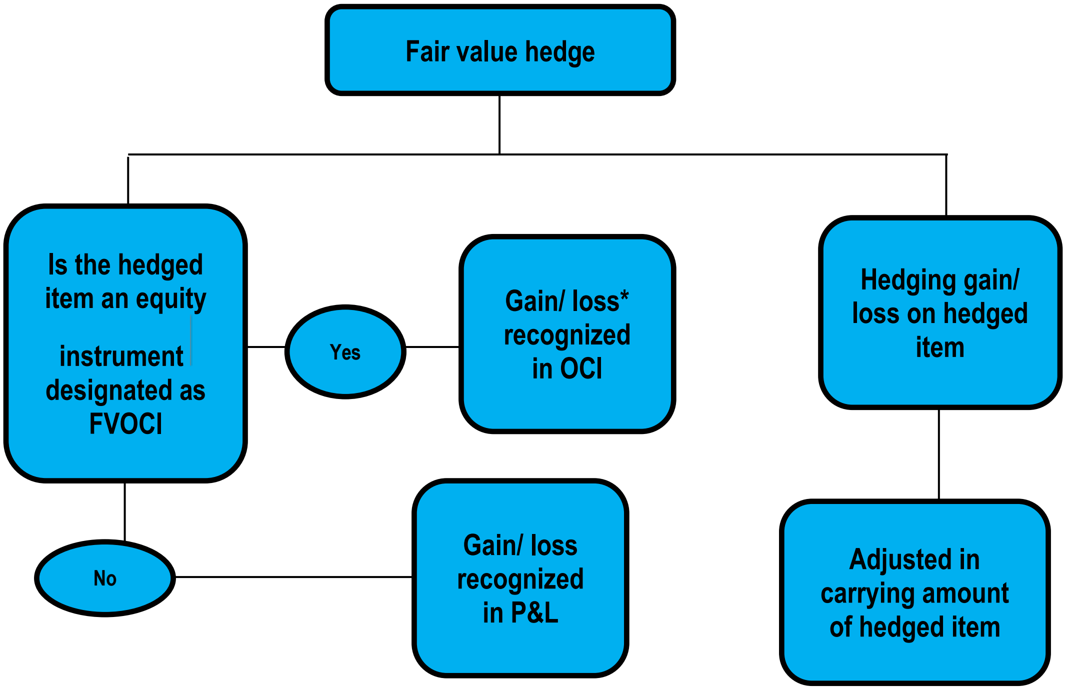
- An entity applies hedge accounting to hedging relationships that meet the qualifying criteria.
- **Types of hedging relationships:**



- **Fair value hedge**

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

Where a fair value hedge meets the qualifying criteria, fair value hedge shall be accounted as follows:



***Gain/ loss comprises both hedging instrument and hedged item**

- If the hedged item is a financial asset (or a component thereof) that is measured at fair value through other comprehensive income (FVOCI) other than equity instrument designated as FVOCI in accordance with Ind AS 109, the hedging gain or loss on the hedged item shall be recognised in profit or loss.
- When a hedged item is an unrecognised firm commitment (or a component thereof), the cumulative change in the fair value of the hedged item subsequent to its designation is recognised as an asset or a liability with a corresponding gain or loss recognised in profit or loss.

- **Cash flow hedge**

A cash flow hedge is a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable debt), or a highly probable forecast transaction, and could affect profit or loss.

Where a cash flow hedge meets the qualifying criteria, it shall be accounted as follows:

(a) the separate component of equity associated with the hedged item (**cash flow hedge reserve**) is adjusted to the lower of the following (in absolute amounts):

i. the cumulative gain or loss on the hedging instrument from inception of the hedge; and

ii. the cumulative change in fair value (present value) of the hedged item (ie the present value of the cumulative change in the hedged expected future cash flows) from inception of the hedge.

(b) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (ie the portion that is offset by the change in the cash flow hedge reserve calculated in accordance with (a)) shall be recognised in other comprehensive income.

(c) any remaining gain or loss on the hedging instrument (or any gain or loss required to balance the change in the cash flow hedge reserve calculated in accordance with (a)) is hedge ineffectiveness that shall be recognised in profit or loss

(d) the amount that has been accumulated in the cash flow hedge reserve in accordance with (a) shall be accounted for as follows:

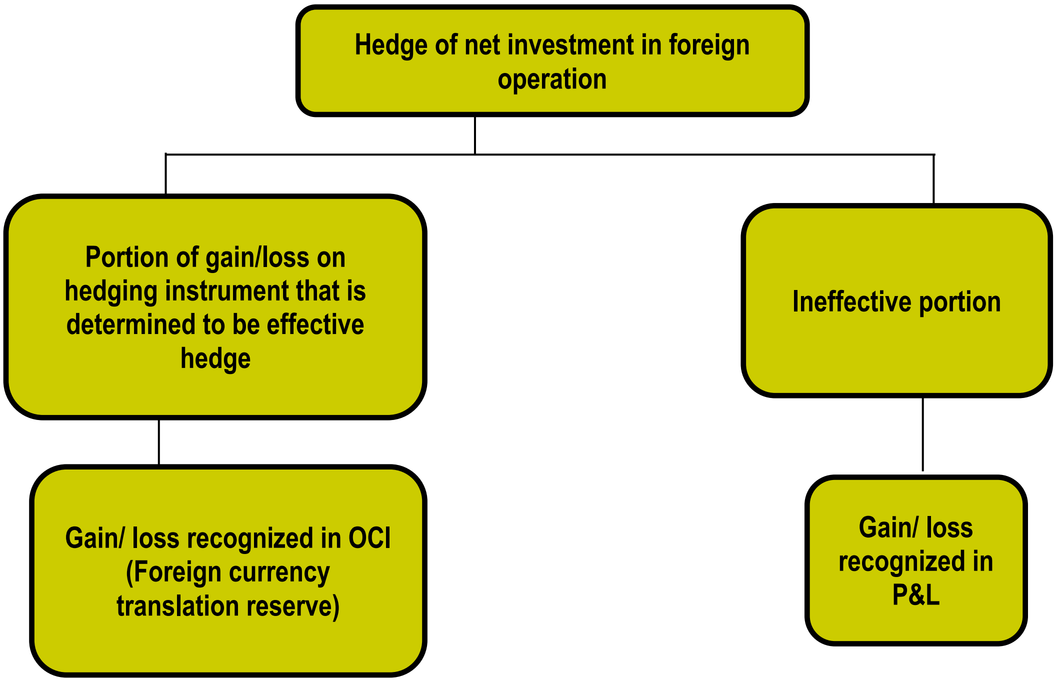
i. If a hedged forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a hedged forecast transaction for a non-financial asset or a non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, the entity shall remove that amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or the liability. This is not a reclassification adjustment as defined in IAS 1 and hence it does not affect other comprehensive income.

ii. For cash flow hedges other than those covered by (i), that amount shall be reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment in the same period or periods during which the hedged expected future cash flows affect profit or loss (for example, in the periods that interest income or interest expense is recognised or when a forecast sale occurs).

iii. However, if that amount is a loss and an entity expects that all or a portion of that loss will not be recovered in one or more future periods, it shall immediately reclassify the amount that is not expected to be recovered into profit or loss as a reclassification adjustment.

- **Hedge of net investment in foreign operation**

  Hedge of a net investment in foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment, shall be accounted for similarly to cash flow hedges:



The cumulative gain or loss on the hedging instrument relating to the effective portion of the hedge that has been accumulated in the foreign currency translation reserve shall be reclassified from equity to profit or loss as a reclassification adjustment on the disposal or partial disposal of the foreign operation.

COMPREHENSIVE ILLUSTRATIONS

Illustration 1

A Ltd. issued redeemable preference shares to a Holding Company – Z Ltd. The terms of the instrument have been summarized below. Account for this in the books of Z Ltd.

Nature	***Non-cumulative redeemable preference shares***
Repayment:	*Redeemable after 5 years*
Date of Allotment:	*1-Apr-20X1*
Date of repayment:	*31-Mar-20X6*
Total period:	*5.00 years*
Value of preference shares issued:	*100,000,000*
Dividend rate	*0.0001%*
Market rate of interest	*12% per annum*
Present value factor	*0.56743*

Solution

Applying the guidance in Ind AS 109, a 'financial asset' shall be recorded at its fair value upon initial recognition. Fair value is normally the transaction price. However, sometimes certain type of instruments may be exchanged at off market terms (ie, different from market terms for a similar instrument if exchanged between market participants).

For example, 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. In such cases where part of the consideration given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument.

In the above case, since A Ltd has issued preference shares to its Holding Company – Z Ltd, the relationship between the parties indicates that the difference in transaction price and fair value is akin to investment made by Z Ltd. in its subsidiary.

Following is the table summarising the computations on initial recognition:

Market rate of interest	12%
Present value factor	0.56743
Present value	56,742,686
Loan component	56,742,686
Investment in subsidiary	43,257,314

Subsequently, such preference shares shall be carried at amortised cost at each reporting date. The computation of amortised cost at each reporting date has been done as follows:

Year	Date	Opening Asset	Days	Interest @ 12%	Closing balance
	1-Apr-20X1				56,742,686
1	31-Mar-20X2	56,742,686	365	6,809,122	63,551,808
2	31-Mar-20X3	63,533,153	365	76,26,217	71,178,025
3	31-Mar-20X4	71,157,131	365	85,41,363	79,719,388
4	31-Mar-20X5	79,695,987	365	95,66,327	89,285,707
5	31-Mar-20X6	89,285,707	365	10,714,285	100,000,000

Journal Entries to be done at every reporting date

Particulars			Amount	Amount
Date of transaction				
	Investment - Equity portion	Dr.	43,257,314	
	Loan receivable	Dr.	56,742,686	
	To Bank			100,000,000
Interest income - March 31, 20X2				
	Loan receivable	Dr.	6,809,122	
	To Interest income			6,809,122
Interest income - March 31, 20X3				
	Loan receivable	Dr.	76,26,217	
	To Interest income			76,26,217
Interest income - March 31, 20X4				
	Loan receivable	Dr.	85,41,363	
	To Interest income			85,41,363
Interest income - March 31, 20X5				
	Loan receivable	Dr.	95,66,327	
	To Interest income			95,66,327
Interest income - March 31, 20X6				
	Loan receivable	Dr.	10,714,285	
	To Interest income			10,714,285

Settlement of transaction				
	Bank	Dr.	100,000,000	
	To Loan receivable			100,000,000

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Illustration 2

A Limited issues INR 1 crore convertible bonds on 1 July 20X1. The bonds have a life of eight years and a face value of INR 10 each, and they offer interest, payable at the end of each financial year, at a rate of 6 per cent annum. The bonds are issued at their face value and each bond can be converted into one ordinary share in A Limited at any time in the next eight years. Companies of a similar risk profile have recently issued debt with similar terms, without the option for conversion, at a rate of 8 per cent per annum.

Required:

(a) Provide the appropriate accounting entries for initial recognition.

(b) Calculate the stream of interest expenses across the eight years of the life of the bonds.

(c) Provide the accounting entries if the holders of the bonds elect to convert the bonds to ordinary shares at the end of the third year.

Solution

(a) Applying the guidance for compound instruments, the present value of the bond is computed to identify the liability component and then difference between the present value of these bonds & the issue price of INR 1 crore shall be allocated to the equity component. In determining the present value, the rate of 8 per cent will be used, which is the interest rate paid on debt of a similar nature and risk that does not provide an option to convert the liability to ordinary shares.

Present value of bonds at the market rate of debt

Present value of principal to be received in eight years discounted at 8%

(10,000,000 X 0.5403)	=	5,403,000
Present value of interest stream discounted at 8% for 8 years		
(6,00,000 X 5.7466)	=	3,447,960
Total present value	=	8,850,960
Equity component	=	1,149,040
Total face value of convertible bonds	=	10,000,000

The accounting entries will be as follows:

	Dr. Amount (INR)	Cr. Amount (INR)
1 July 20X1		
Cash Dr.	10,000,000	
To Convertible bonds (liability)		8,850,960
To Convertible bonds (equity component)		1,149,040
(Being entry to record the convertible bonds and the recognition of the liability and equity components)		
30 June 20X2		
Interest expense Dr.	708,077	
To Cash		600,000
To Convertible bonds (liability)		108,077
(Being entry to record the interest expense, where the expense equals the present value of the opening liability multiplied by the market rate of interest).		

(b) The stream of interest expense is summarised below, where interest for a given year is calculated by multiplying the present value of the liability at the beginning of the period by the market rate of interest, this is being 8 per cent.

Date	Payment	Interest expense at 8%	Increase in bond liability	Total bond liability
01 July 20X1				8,850,960
30 June 20X2	600,000	708,077	108,077	8,959,037
30 June 20X3	600,000	716,723	116,723	9,075,760
30 June 20X4	600,000	726,061	126,061	9,201,821
30 June 20X5	600,000	736,146	136,146	9,337,967
30 June 20X6	600,000	747,037	147,037	9,485,004
30 June 20X7	600,000	758,800	158,800	9,643,804
30 June 20X8	600,000	771,504	171,504	9,815,308
30 June 20X9	600,000	784,692*	184,692	10,000,000

*difference is due to rounding off

(c) If the holders of the bonds elect to convert the bonds to ordinary shares at the end of the third year (after receiving their interest payments), the entries in the third year would be:

		Dr. Amount (INR)	Cr. Amount (INR)
30 June 20X4			
Interest expense	Dr.	726,061	
To Cash			600,000
To Convertible bonds (liability)			126,061
(Being entry to record interest expense for the period)			
30 June 20X4			
Convertible bonds (liability)	Dr.	9,201,821	
Convertible bonds (equity component)	Dr.	1,149,040	
To Ordinary share capital A/c			10,350,861
(Being entry to record the conversion of bonds into shares of A Limited)			

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Illustration 3

On 1st January 20X1, SamCo. Ltd. agreed to purchase USD ($) 20,000 from JT Bank in future on 31st December 20X1 for a rate equal to ₹ 68 per USD. SamCo. Ltd. did not pay any amount upon entering into the contract. SamCo Ltd. is a listed company in India and prepares its financial statements on a quarterly basis.

Following the principles of recognition and measurement as laid down in Ind AS 109, you are required to record the entries for each quarter ended till the date of actual purchase of USD.

For the purposes of accounting, please use the following information representing marked to market fair value of forward contracts at each reporting date:

As at 31st March 20X1 – ₹ (25,000)

As at 30th June 20X1 - ₹ (15,000)

As at 30th September 20X1 - ₹ 12,000

Spot rate of USD on 31st December 20X1 - ₹ 66 per USD

Solution

(i) Assessment of the arrangement using the definition of derivative included under Ind AS 109

> Derivative is a financial instrument or other contract within the scope of this Standard with all three of the following characteristics:
>
> a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates,

credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').

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

c) it is settled at a future date.

Upon evaluation of contract in question it is noted that the contract meets the definition of a derivative as follows:

a) the value of the contract to purchase USD at a fixed price changes in response to changes in foreign exchange rate.

b) the initial amount paid to enter into the contract is zero. A contract which would give the holder a similar response to foreign exchange rate changes would have required an investment of USD 20,000 on inception.

c) the contract is settled in future

The derivative is a forward exchange contract.

As per Ind AS 109, derivatives are measured at fair value upon initial recognition and are subsequently measured at fair value through profit and loss.

(ii) Accounting on 1st January 20X1:

As there was no consideration paid and without evidence to the contrary the fair value of the contract on the date of inception is considered to be zero. Accordingly, no accounting entries shall be recorded on the date of entering into the contract.

(iii) Accounting on 31st March 20X1:

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Profit and loss A/c Dr.	25,000	
To derivative financial liability		25,000
(Being mark to market loss on forward contract recorded)		

(iv) Accounting on 30th June 20X1:

The change in value of the derivative forward contract shall be recorded as a derivative financial liability in the books of SamCo Ltd. by recording the following journal entry:

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Derivative financial liability A/c Dr.	10,000	
To Profit and loss A/c		10,000
(being partial reversal of mark to market loss on forward contract recorded)		

(v) Accounting on 30th September 20X1:

The value of the derivative forward contract shall be recorded as a derivative financial asset in the books of SamCo Ltd. by recording the following journal entry:

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Derivative financial liability A/c Dr	15,000	
Derivative financial asset A/c Dr	12,000	
To Profit and loss A/c		27,000
(being gain on mark to market of forward contract booked as derivative financial asset and reversal of derivative financial liability)		

(vi) Accounting on 31st December 20X1:

The settlement of the derivative forward contract by actual purchase of USD 20,000 shall be recorded in the books of SamCo Ltd. by recording the following journal entry:

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Cash (USD Account) @ 20,000 * 66 Dr.	13,20,000	
Profit and loss A/c Dr.	52,000	
To Cash @ 20,000 x 68		13,60,000
To Derivative financial asset A/c		12,000
(being loss on settlement of forward contract booked on actual purchase of USD)		

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Illustration 4

Entity A (an INR functional currency entity) enters into a USD 1,000,000 sale contract on 1 January 20X1 with Entity B (an INR functional currency entity) to sell equipment on 30 June 20X1.

Spot rate on 1 January 20X1: INR/USD	*45*

Spot rate on 31 March 20X1: INR/USD	*57*
Three-month forward rate on 31 March 20X1: INR/USD	*45*
Six-month forward rate on 1 January 20X1: INR/USD	*55*
Spot rate on 30 June 20X1: INR/USD	*60*

Assume that this contract has an embedded derivative that is not closely related and requires separation. Please provide detailed journal entries in the books of Entity A for accounting of such embedded derivative until sale is actually made.

Solution

The contract should be separated using the 6 month USD/INR forward exchange rate, as at the date of the contract (INR/USD = 55). The two components of the contract are therefore:

- A sale contract for INR 55 Million
- A six-month currency forward to purchase USD 1 Million at 55
- This gives rise to a gain or loss on the derivative, and a corresponding derivative asset or liability.

<u>On delivery</u>

1. Entity A records the sales at the amount of the host contract = INR 55 Million
2. The embedded derivative is considered to expire.
3. The derivative asset or liability (i.e. the cumulative gain or loss) is settled by becoming part of the financial asset on delivery.
4. In this case the carrying value of the currency forward at 30 June 20X1 on maturity is = INR (1,000,000 x 60 – 55 x 1,000,000) = ₹ 5,000,000 (profit/asset)

The table summarising the computation of gain/ loss to be recorded at every period end -

Date	**Transaction**	**Sales**	**Debtors**	**Derivative Asset (Liability)**	**(Profit) Loss**
		INR	INR	INR	INR
1-Jan-20X1	Embedded Derivative	Nil Value			
31-Mar-20X1	Change in Fair Value of Embedded Derivatives MTM (55-45) x 1 Million			(10,000,000)	10,000,000
30-Jun-20X1	Change in Fair Value of Embedded Derivatives (60-45) x 1 Million			15,000,000	(15,000,000)

30-Jun-20X1	Recording sales at forward rate	(55,000,000)	55,000,000		
30-Jun-20X1	Embedded derivative-settled against debtors		5,000,000	(5,000,000)	

Journal Entries to be recorded at every period end

a. 01 January 20X1 – No entry to be made

b. 31 March 20X1 –

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Profit and loss A/c Dr.	10,000,000	
To Derivative financial liability A/c		10,000,000
(being loss on mark to market of embedded derivative booked)		

c. 30 June 20X1 –

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Derivative financial asset A/c Dr.	5,000,000	
Derivative financial liability A/c Dr.	10,000,000	
To Profit and loss A/c		15,000,000
(being gain on embedded derivative based on spot rate at the date of settlement booked)		

d. 30 June 20X1 –

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Trade receivable A/c Dr.	55,000,000	
To Sales A/c		55,000,000
(being sale booked at forward rate on the date of transaction)		

e. 30 June 20X1 –

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Trade receivable A/c Dr	5,000,000	

To Derivative financial asset A/c (being derivative asset re-classified as a part of trade receivables, bringing it to spot rate on the date of sale)		5,000,000

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Illustration 5

On 1st January 20X1, SamCo. Ltd. entered into a written put option for USD ($) 20,000 with JT Corp to be settled in future on 31st December 20X1 for a rate equal to ₹ 68 per USD at the option of JT Corp. SamCo. Ltd. did not receive any amount upon entering into the contract. SamCo Ltd. is a listed company in India and prepares its financial statements on a quarterly basis.

Following the classification principles of recognition and measurement as laid down in Ind AS 109, you are required to record the entries for each quarter ended till the date of actual purchase of USD.

For the purposes of accounting, please use the following information representing marked to market fair value of put option contracts at each reporting date:

As at 31st March 20X1 – ₹ (25,000)

As at 30th June 20X1 - ₹ (15,000)

As at 30th September 20X1 - ₹ NIL

Spot rate of USD on 31st December 20X1 - ₹ 66 per USD

Solution

i. **Assessment of the arrangement using the definition of derivative included under Ind AS 109**

Derivative is a financial instrument or other contract within the scope of this Standard with all three of the following characteristics: a. its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying'). b. it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. c. it is settled at a future date.

Upon evaluation of contract in question it is noted that the contract meets the definition of a derivative as follows:

a) the value of the contract to purchase USD at a fixed price changes in response to changes in foreign exchange rate.

d) the initial amount received to enter into the contract is zero. A contract which would give the holder a similar response to foreign exchange rate changes would have required an investment of USD 20,000 on inception.

e) the contract is settled in future

The derivative liability is a written put option contract.

As per Ind AS 109, derivatives are measured at fair value upon initial recognition and are subsequently measured at fair value through profit and loss.

ii. Accounting on 1st January 20X1

As there was no consideration paid and without evidence to the contrary the fair value of the contract on the date of inception is considered to be zero. Accordingly, no accounting entries shall be recorded on the date of entering into the contract.

iii. Accounting on 31st March 20X1

The value of the derivative put option contract shall be recorded as a derivative financial liability in the books of SamCo Ltd. by recording the following journal entry:

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Profit and loss A/c Dr.	25,000	
To derivative financial liability		25,000
(Being mark to market loss on the put option contract recorded)		

iv. Accounting on 30th June 20X1

The change in value of the derivative put option contract shall be recorded as a derivative financial liability in the books of SamCo Ltd. by recording the following journal entry:

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Derivative financial liability A/c Dr.	10,000	
To Profit and loss A/c		10,000
(Being partial reversal of mark to market loss on the put option contract recorded)		

v. Accounting on 30th September 20X1

The change in value of the derivative option contract shall be recorded as a zero in the books of SamCo Ltd. by recording the following journal entry:

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Derivative financial liability A/c Dr.	15,000	
To Profit and loss A/c		15,000
(Being gain on mark to market of put option contract booked to make the value the derivative liability as zero)		

vi. Accounting on 31st December 20X1

The settlement of the derivative put option contract by actual purchase of USD 20,000 shall be recorded in the books of SamCo Ltd. upon exercise by JT Corp. by recording the following journal entry:

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Cash (USD Account) @ 20,000 x 66 Dr.	13,20,000	
Profit and loss A/c Dr.	40,000	
To Cash @ 20,000 x 68		13,60,000
(being loss on settlement of put option contract booked on actual purchase of USD)		

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Illustration 6

ABC Company issued 10,000 compulsory cumulative convertible preference shares (CCCPS) as on 1 April 20X1 @ ₹ 150 each. The rate of dividend is 10% payable every year. The preference shares are convertible into 5,000 equity shares of the company at the end of 5th year from the date of allotment. When the CCCPS are issued, the prevailing market interest rate for similar debt without conversion options is 15% per annum. Transaction cost on the date of issuance is 2% of the value of the proceeds.

Key terms:

Date of Allotment	*01-Apr-20X1*
Date of Conversion	*01-Apr-20X6*
Number of Preference Shares	*10,000*
Face Value of Preference Shares	*150*
Total Proceeds	*15,00,000*
Rate of dividend	*10%*

Market Rate for Similar Instrument	*15%*
Transaction Cost	*30,000*
Face value of equity share after conversion	*10*
Number of equity shares to be issued	*5,000*
Effective interest rate	*15.86%*

You are required to compute the liability and equity component and pass journal entries for entire term of arrangement i.e. from the issue of preference shares till their conversion into equity shares keeping in view the provisions of relevant Ind AS.

Solution

This is a compound financial instrument with two components – liability representing present value of future cash outflows and balance represents equity component.

a. Computation of Liability & Equity Component

Date	Particulars	Cash Flow	Discount Factor	Net present Value
01-Apr-20X1		0	1	0.00
31-Mar-20X2	Dividend	150,000	0.869565	130,434.75
31-Mar-20X3	Dividend	150,000	0.756144	113,421.6
31-Mar-20X4	Dividend	150,000	0.657516	98,627.4
31-Mar-20X5	Dividend	150,000	0.571753	85,762.95
31-Mar-20X6	Dividend	150,000	0.497177	74,576.55
Total Liability Component				502,823.25
Total Proceeds				1,500,000.00
Total Equity Component (Bal fig)				997,176.75

b. Allocation of transaction costs

Particulars	Amount	Allocation	Net Amount
Liability Component	502,823	10,056	492,767
Equity Component	997,177	19,944	977,233
Total Proceeds	1,500,000	30,000	1,470,000

c. Accounting for liability at amortised cost:

- Initial accounting = Present value of cash outflows less transaction costs
- Subsequent accounting = At amortised cost, ie, initial fair value adjusted for interest and repayments of the liability.

Assume the effective interest rate is 15.86%

	Opening Financial Liability A	Interest B	Cash Flow C	Closing Financial Liability A+B-C
01-Apr-20X1	492,767	-	-	4,92,767
31-Mar-20X2	492,767	78,153	150,000	4,20,920
31-Mar-20X3	420,920	66,758	150,000	3,37,678
31-Mar-20X4	337,678	53,556	150,000	2,41,234
31-Mar-20X5	241,234	38,260	150,000	1,29,494
31-Mar-20X6	129,494	20,506	150,000	-

d. Journal Entries to be recorded for entire term of arrangement are as follows:

Date	Particulars	Debit	Credit
01-Apr-20X1	Bank A/c Dr.	1,470,000	
	To Preference Shares A/c		492,767
	To Equity Component of Preference shares A/c		977,233
	(Being compulsorily convertible preference shares issued. The same are divided into equity component and liability component as per the calculation)		
31-Mar-20X2	Preference shares A/c Dr.	150,000	
	To Bank A/c		150,000
	(Being Dividend at the coupon rate of 10% paid to the shareholders)		
31-Mar-20X2	Finance cost A/c Dr.	78,153	
	To Preference Shares A/c		78,153
	(Being interest as per EIR method recorded)		
31-Mar-20X3	Preference shares A/c Dr.	150,000	

	To Bank A/c (Being Dividend at the coupon rate of 10% paid to the shareholders)		150,000
31-Mar-20X3	Finance cost A/c Dr. To Preference Shares A/c (Being interest as per EIR method recorded)	66,758	66,758
31-Mar-20X4	Preference shares A/c Dr. To Bank A/c (Being Dividend at the coupon rate of 10% paid to the shareholders)	150,000	150,000
31-Mar-20X4	Finance cost A/c Dr. To Preference Shares A/c (Being interest as per EIR method recorded)	53,556	53,556
31-Mar-20X5	Preference shares A/c Dr. To Bank A/c (Being Dividend at the coupon rate of 10% paid to the shareholders)	150,000	150,000
31-Mar-20X5	Finance cost A/c Dr. To Preference Shares A/c (Being interest as per EIR method recorded)	38,260	38,260
31-Mar-20X6	Preference shares A/c Dr. To Bank A/c (Being Dividend at the coupon rate of 10% paid to the shareholders)	150,000	150,000
31-Mar-20X6	Finance cost A/c Dr. To Preference Shares A/c (Being interest as per EIR method recorded)	20,506	20,506
31-Mar-20X6	Equity Component of Preference shares A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Being Preference shares converted in equity shares and remaining equity component is recognised as securities premium)	977,233	50,000 927,233

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TEST YOUR KNOWLEDGE

Questions

1. As part of staff welfare measures, Y Co Ltd. has contracted to lend to its employees sums of money at 5% per annum rate of interest. The amounts lent are to be repaid in five equal instalments for principle along with the interest. The market rate of interest is 10% per annum for comparable loans. Y lent ₹ 1,600,000 to its employees on 1st January 20X1.

Following the principles of recognition and measurement as laid down in Ind AS 109, you are required to record the entries for the year ended 31 December 20X1, for the transaction and also compute the value of loan initially to be recognised and amortised cost for all subsequent years.

For the purpose of calculation, following discount factors at interest rate of 10% per annum may be adopted –

At the end of year –

Year	Present value factor
1	.909
2	.827
3	.751
4	.683
5	.620

2. Wheel Co. Limited has a policy of providing subsidized loans to its employees for the purpose of buying or building houses. Mr. X, who's executive assistant to the CEO of Wheel Co. Limited, took a loan from the Company on the following terms:

- Principal amount: 1,000,000
- Interest rate: 4% for the first 400,000 and 7% for the next 600,000
- Start date: 1 January 20X1
- Tenure: 5 years
- Pre-payment: Full or partial pre-payment at the option of the employee
- The principal amount of loan shall be recovered in 5 equal annual instalments and will be first applied to 7% interest bearing principal
- The accrued interest shall be paid on an annual basis
- Mr. X must remain in service till the term of the loan ends

The market rate of a comparable loan available to Mr. X, is 12% per annum.

Following table shows the contractually expected cash flows from the loan given to Mr. X:

(amount in ₹)

		Inflows			
Date	**Outflows**	**Principal**	**Interest income 7%**	**Interest income 4%**	**Principal outstanding**
1-Jan-20X1	(1,000,000)				1,000,000
31-Dec-20X1		200,000	42,000	16,000	800,000
31-Dec-20X2		200,000	28,000	16,000	600,000
31-Dec-20X3		200,000	14,000	16,000	400,000
31-Dec-20X4		200,000	-	16,000	200,000
31-Dec-20X5		200,000	-	8,000	-

Mr. S, pre-pays ₹ 200,000 on 31 December 20X2, reducing the outstanding principal as at that date to ₹ 400,000.

Following table shows the actual cash flows from the loan given to Mr. X, considering the pre-payment event on 31 December 20X2: **(amount in ₹)**

		Inflows			
Date	**Outflows**	**Principal**	**Interest income 7%**	**Interest income 4%**	**Principal outstanding**
1-Jan-20X1	(1,000,000)				1,000,000
31-Dec-20X1		200,000	42,000	16,000	800,000
31-Dec-20X2		400,000	28,000	16,000	400,000
31-Dec-20X3		200,000	-	16,000	200,000
31-Dec-20X4		200,000	-	8,000	-
31-Dec-20X5		-	-	-	-

Record journal entries in the books of Wheel Co. Limited considering the requirements of Ind AS 109.

3. Wheel Co. Limited borrowed ₹ 500,000,000 from a bank on 1 January 20X1. The original terms of the loan were as follows:

- Interest rate: 11%
- Repayment of principal in 5 equal instalments
- Payment of interest annually on accrual basis

- Upfront processing fee: ₹ 5,870,096

Effective interest rate on loan: 11.50%

On 31 December 20X2, Wheel Co. Limited approached the bank citing liquidity issues in meeting the cash flows required for immediate instalments and re-negotiated the terms of the loan with banks as follows:

- Interest rate 15%
- Repayment of outstanding principal in 10 equal instalments starting 31 December 20X3
- Payment of interest on an annual basis

Record journal entries in the books of Wheel Co. Limited till 31 December 20X3, after giving effect of the changes in the terms of the loan on 31 December 20X2

4. K ltd. issued 500,000, 6% convertible debentures @ ₹ 10 each on 01 April 20X1. The debentures are due for redemption on 31 March 20X5 at a premium of 10%, convertible into equity shares to the extent of 50% and balance to be settled in cash to the debenture holders. The interest rate on equivalent debentures without conversion rights was 10%.

You are required to separate the debt and equity components at the time of issue and show the accounting entries in Company's books at initial recognition. The following present values of Re 1 at 6% and at 10% are provided:

Interest rate	Year 1	Year 2	Year 3	Year 4
6%	0.94	0.89	0.84	0.79
10%	0.91	0.83	0.75	0.68

5. On 1 April 20X1, an 8% convertible loan with a nominal value of ₹ 6,00,000 was issued at par. It is redeemable on 31 March 20X5 also at par. Alternatively, it may be converted into equity shares on the basis of 100 new shares for each ₹ 200 worth of loan.

An equivalent loan without the conversion option would have carried interest at 10%. Interest of ₹ 48,000 has already been paid and included as a finance cost.

Present value rates are as follows:

Year End	@ 8%	@ 10%
1	0.93	0.91
2	0.86	0.83
3	0.79	0.75
4	0.73	0.68

How will the Company present the above loan notes in the financial statements for the year ended 31 March 20X2?

Answers

1. (i) **Calculation of initial recognition amount of loan to its employees:**

Year end	Cash flow		Total	PV factor	Present value
	Principal	Interest @ 5%			
20X1	320,000	80,000	400,000	.909	363,600
20X2	320,000	64,000	384,000	.827	317,568
20X3	320,000	48,000	368,000	.751	276,368
20X4	320,000	32,000	352,000	.683	240,416
20X5	320,000	16,000	336,000	.620	208,320
					1,406,272

(ii) **Calculation of amortised cost of loan to employees**

Year end	Amortised cost (opening balance)	Interest to be recognised	Repayment (including interest)	Amortised cost (closing balance)
20X1	1,406,272	140,627	400,000	1,146,899
20X2	1,146,899	114,690	384,000	877,589
20X3	877,589	87,759	368,000	597,348
20X4	597,348	59,735	352,000	305,083
20X5	305,083	30,917*	336,000	-

*305,083 * 10% = 30,508. Difference of ₹ 409 is due to approximation in computation.

(iii) **Journal Entries to be recorded of Y Ltd. for the year ended 31 December 20X1**

Particulars		Debit	Credit
Staff loan A/c	Dr.	16,00,000	
To Bank A/c			16,00,000
(Being disbursement of loans to staff)			

Prepaid staff cost A/c* Dr. [(1,600,000 – 1,406,272), Refer part (ii)]	1,93,728	
To Staff loan A/c		1,93,728
(Being the excess loan balance over present value thereof in order to reflect the loan at its present value booked as prepaid)		
Staff loan A/c Dr.	1,40,627	
To Interest expense A/c		1,40,627
(Being interest accrued on loans to staff)		
Staff cost A/c Dr.	38,746	
To Prepaid expense A/c		38,746
(Being interest accrued on loans to staff)		

* Where the difference between the amount given by the Company to its employees and its fair value represents another asset, then such asset shall be recognised. Accordingly, such difference is recognised as prepaid employee cost and amortised over the period of loan.

2. As per requirement of Ind AS 109, a financial instrument is initially measured and recorded at its fair value. Therefore, considering the market rate of interest of similar loan available to Mr. X is 12%, the fair value of the contractual cash flows shall be as follows:

	Inflows			Discount factor @12%	
Date	**Principal**	**Interest income 7%**	**Interest income 4%**		**PV**
31-Dec-20X1	200,000	42,000	16,000	0.8929	2,30,357
31-Dec-20X2	200,000	28,000	16,000	0.7972	1,94,515
31-Dec-20X3	200,000	14,000	16,000	0.7118	1,63,709
31-Dec-20X4	200,000	-	16,000	0.6355	1,37,272
31-Dec-20X5	200,000	-	8,000	0.5674	1,18,025
Total (fair value)					8,43,878

Benefit to Mr. X, to be considered a part of employee cost for Wheel Co. ₹ 1,56,121.

The deemed employee cost is to be amortised over the period of loan i.e. the minimum period that Mr. X must remain in service.

The amortization schedule of the ₹ 843,878 loan is shown in the following table:

Date	Loan outstanding	Total cash inflows (principal repayment + interest	Interest @ 12%
1-Jan-20X1	843,878		
31-Dec-20X1	687,143	258,000	101,265
31-Dec-20X2	525,600	244,000	82,457
31-Dec-20X3	358,672	230,000	63,072
31-Dec-20X4	185,713	216,000	43,041
31-Dec-20X5	(0)	208,000	22,287

Journal Entries to be recorded at every period end:

a. 1 January 20X1 –

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Loan to employee A/c	Dr.	843,879	
Pre-paid employee cost A/c	Dr	156,121	
To Cash A/c			1,000,000
(Being loan asset recorded at initial fair value)			

b. 31 December 20X1 –

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Cash A/c	Dr.	258,000	
To Interest income (profit and loss) @12% A/c			101,265
To loan to employee A/c			156,735
(Being first instalment of repayment of loan accounted for using the amortised cost and effective interest rate of 12%)			
Employee benefit (profit and loss) A/c	Dr.	31,224	
To Pre-paid employee cost A/c			31,224
(Being amortization of pre-paid employee cost charged to profit and loss as employee benefit cost)			

On 31 December 20X2, due to pre-payment of a part of loan by Mr. X, the carrying value of the loan shall be re-computed by discounting the future remaining cash flows by the original effective interest rate.

There shall be two sets of accounting entries on 31 December 20X2, first the realisation of the contractual cash flow as shown in (c) below and then the accounting for the pre-payment of ₹ 200,000 included in (d) below:

c. 31 December 20X2 –

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Cash A/c Dr. To Interest income (profit and loss) @12% A/c To loan to employee A/c (Being second instalment of repayment of loan accounted for using the amortised cost and effective interest rate of 12%)	244,000	 82,457 161,543
Employee benefit (profit and loss) A/c Dr To Pre-paid employee cost A/c (Being amortization of pre-paid employee cost charged to profit and loss as employee benefit cost)	31,224	 31,224

Computation of new carrying value of loan to employee:

	Inflows			Discount factor @12%	
Date	Principal	Interest income 7%	Interest income 4%		PV
31-Dec-20X3	200,000	-	16,000	0.8929	192,857
31-Dec-20X4	200,000	-	8,000	0.7972	165,816
Total (revised carrying value)					358,673
Less: Current carrying value					525,601
Adjustment required					166,928

The difference between the amount of pre-payment and adjustment to loan shall be considered a gain, though will be recorded as an adjustment to pre-paid employee cost, which shall be amortised over the remaining tenure of the loan.

d. 31 December 20X2 prepayment–

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Cash A/c Dr. To Pre-paid employee cost A/c	200,000	 33,072

To loan to employee A/c (Being gain to Wheel Co. Limited recorded as an adjustment to pre-paid employee cost)		166,928

The amortisation schedule of the new carrying amount of loan shall be as follows:

Date	Loan outstanding	Total cash inflows (principal repayment + interest	Interest @ 12%
31-Dec-20X2	358,673		
31-Dec-20X3	185,714	216,000	43,041
31-Dec-20X4	-	208,000	22,286

Amortisation of employee benefit cost shall be as follows:

Date	Balance	Amortised to P&L	Adjustment
1-Jan-20X1	156,121		
31-Dec-20X1	124,897	31,224	
31-Dec-20X2	60,601	31,224	33,072
31-Dec-20X3	30,300	30,300	
31-Dec-20X4	-	30,300	

e. 31 December 20X3 –

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Cash A/c Dr. To Interest income (profit and loss) @12% A/c To loan to employee A/c (Being third instalment of repayment of loan accounted for using the amortised cost and effective interest rate of 12%)	216,000	 43,041 172,959
Employee benefit (profit and loss) A/c Dr To Pre-paid employee cost A/c (Being amortization of pre-paid employee cost charged to profit and loss as employee benefit cost)	30,300	 30,300

f. 31 December 20X4 –

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Cash A/c Dr	208,000	
To Interest income (profit and loss) @12% A/c		22,286
To loan to employee A/c		185,714
(Being last instalment of repayment of loan accounted for using the amortised cost and effective interest rate of 12%)		
Employee benefit (profit and loss) A/c Dr	30,300	
To Pre-paid employee cost A/c		30,300
(Being amortization of pre-paid employee cost charged to profit and loss as employee benefit cost)		

3. On the date of initial recognition, the effective interest rate of the loan shall be computed keeping in view the contractual cash flows and upfront processing fee paid. The following table shows the amortisation of loan based on effective interest rate:

Date	Cash flows (principal)	Cash flows (interest and fee)	Amortised cost (opening + interest – cash flows)	Interest @ EIR (11.50%)
1-Jan-20X1	(500,000,000)	5,870,096	494,129,904	
31-Dec-20X1	100,000,000	55,000,000	395,954,843	56,824,939
31-Dec-20X2	100,000,000	44,000,000	297,489,650	45,534,807
31-Dec-20X3	100,000,000	33,000,000	198,700,959	34,211,310
31-Dec-20X4	100,000,000	22,000,000	99,551,570	22,850,610
31-Dec-20X5	100,000,000	11,000,000	(0)	11,448,430

a. 1 January 20X1 –

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Cash A/c Dr.	494,129,904	
To Loan from bank A/c		494,129,904
(Being loan recorded at its fair value less transaction costs on the initial recognition date)		

b. **31 December 20X1 –**

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Loan from bank A/c	Dr.	98,175,061	
Interest expense (profit and loss)	Dr.	56,824,939	
To Cash A/c			155,000,000
(Being first instalment of loan and payment of interest accounted for as an adjustment to the amortised cost of loan)			

c. **31 December 20X2 – Before Wheel Co. Limited approached the bank –**

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Interest expense (profit and loss)	Dr.	45,534,807	
To Loan from bank A/c			1,534,807
To cash A/c			44,000,000
(Being loan payment of interest recorded by the Company before it approached the Bank for deferment of principal)			

Upon receiving the new terms of the loan, Wheel Co. Limited, re-computed the carrying value of the loan by discounting the new cash flows with the original effective interest rate and comparing the same with the current carrying value of the loan. As per requirements of Ind AS 109, any change of more than 10% shall be considered a substantial modification, resulting in fresh accounting for the new loan:

Date	Cash flows (principal)	Interest outflow @15%	Discount factor	PV of cash flows
31-Dec-20X2	(400,000,000)			
31-Dec-20X3	40,000,000	60,000,000	0.8969	89,686,099
31-Dec-20X4	40,000,000	54,000,000	0.8044	75,609,805
31-Dec-20X5	40,000,000	48,000,000	0.7214	63,483,092
31-Dec-20X6	40,000,000	42,000,000	0.6470	53,053,542
31-Dec-20X7	40,000,000	36,000,000	0.5803	44,100,068
31-Dec-20X8	40,000,000	30,000,000	0.5204	36,429,133

31-Dec-20X9	40,000,000	24,000,000	0.4667	29,871,422
31-Dec-20Y0	40,000,000	18,000,000	0.4186	24,278,903
31-Dec-20Y1	40,000,000	12,000,000	0.3754	19,522,235
31-Dec-20Y3	40,000,000	6,000,000	0.3367	15,488,493
PV of new contractual cash flows discounted at 11.50%				451,522,791
Carrying amount of loan				397,489,650
Difference				54,033,141
Percentage of carrying amount				13.59%

Note: Calculation above done on full decimal, though in the table discount factor is limited to 4 decimals.

Considering a more than 10% change in PV of cash flows compared to the carrying value of the loan, the existing loan shall be considered to have been extinguished and the new loan shall be accounted for as a separate financial liability. The accounting entries for the same are included below:

d. 31 December 20X2 – accounting for extinguishment

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Loan from bank (old) A/c	Dr	397,489,650	
Finance cost (profit and loss)	Dr	2,510,350	
To Loan from bank (new) A/c			400,000,000
(Being new loan accounted for at its principal amount in absence of any transaction costs directly related to such loan and correspondingly a de-recognition of existing loan)			

e. 31 December 20X3

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Loan from bank A/c	Dr.	40,000,000	
Interest expense (profit and loss)	Dr.	60,000,000	
To cash A/c			100,000,000
(Being first instalment of the new loan and payment of interest accounted for as an adjustment to the amortised cost of loan)			

4. Computation of debt component of convertible debentures on 01 April 20X1

Particulars	Amount
Present value of principal amount repayable after 4 years	
(A) 5,000,000 * 50% * 1.10 * 0.68 (10% discount factor)	1,870,000
(B) Present value of interest [300,000 * 3.17] (4 years cumulative 10% discount factor)	951,000
Total present value of debt component (A) + (B)	2,821,000
Issue proceeds from convertible debentures	5,000,000
Value of equity component	2,179,000

Journal entry at initial recognition

Particulars		Dr. Amount (₹)	Cr. Amount (₹)
Bank A/c	Dr.	5,000,000	
To 6% debenture A/c (liability component)			2,821,000
To 6% debenture A/c (equity component)			2,179,000
(Being disbursement recorded at fair value)			

5.

Step 1 There is an 'option' to convert the loans into equity i.e. the loan note holders do not have to accept equity shares; they could demand repayment in the form of cash.

Ind AS 32 states that where there is an obligation to transfer economic benefits there should be a liability recognised. On the other hand, where there is not an obligation to transfer economic benefits, a financial instrument should be recognised as equity.

In the above illustration we have both – 'equity' and 'debt' features in the instrument. There is an obligation to pay cash – i.e. interest at 8% per annum and a redemption amount – this is 'financial liability' or 'debt component'. The 'equity' part of the transaction is the option to convert. So it is a compound financial instrument.

Step 2 Debt element of the financial instrument so as to recognise the liability is the present value of interest and principal

The rate at which the same is to be discounted, is the rate of *equivalent* loan note *without* the conversion option would have carried interest at 10%, therefore this is the rate to be used for discounting

Step 3 Calculation of the debt element of the loan note as follows:

8% Interest discounted at a rate of 10% Present Value (6,00,000 x 8%)

S. No	Year	Interest amount	PVF	Amount
Year 1	20X2	48,000	0.91	43,680
Year 2	20X3	48,000	0.83	39,840
Year 3	20X4	48,000	0.75	36,063
				1,19,583
Year 4	20X5	648,000	0.68	4,40,640
Amount to be recognised as a liability				5,60,223

Initial proceeds	(6,00,000)
Amount to be recognised as equity	39,777

* In year 4, the loan note is redeemed therefore ₹ 6,00,000 + ₹ 48,000 = ₹ 6,48,000.

Step 4 The next step is to recognise the interest component equivalent to the loan that would carry if there was no option to cover. Therefore, the interest should be recognised at 10%. As on date ₹ 48,000 has been recognised in the statement of profit and loss i.e. 6,00,000 x 8% but we have discounted the present value of future interest payments and redemption amount using discount factors of 10%, so the finance charge in the statement of profit and loss must also be recognised at the same rate i.e. for the purpose of consistency.

The additional charge to be recognised in the income statement is calculated as:

Debt component of the financial instrument ₹ 5,60,000

Interest charge (5,60,000 x 10%)	₹ 56,000
Already charged to the income statement	(₹ 48,000)
Additional charge required	₹ 8,000

Journal Entries for recording additional finance cost for year ended 31 March 20X2

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Finance cost A/c Dr.	8,000	
To Debt component A/c		8,000
(Being interest recorded for difference between amount recorded earlier and that to be recorded per Ind AS 32)		

Final Course

(Revised Scheme of Education and Training)

Study Material

Paper 1

Financial Reporting

Module 4 of 4

BOARD OF STUDIES

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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SIGNIFICANT CHANGES

Significant changes in this Module 4 *vis-à-vis* Module 5 and Module 6 (relevant portion) of November, 2018 edition of the Study Material

(The amendments made in the respective chapters / units have been highlighted in bold and italics for easy reference except newly added illustrations)

Chapter No.	Title of the chapter	Detail
13	Business Combination	• Para 11.1 has been amended • In Table given in Para 12.2.1, item 'Leases' has been amended • Illustration 36 (given in the Nov. 2018 edition of Module 5 of the Study Material) has been removed
14	Consolidated and separate financial statements	• In Unit 4, Illustrations 1, 2, 9 and 26 have been newly added • In Unit 5, Illustrations 8, 20, 21 and 28 have been newly added • In Unit 6, Illustrations 20 and 21 have been newly added • In Unit 7, Illustration 8 has been newly added; para 7.6.1 has been amended. • In test Your Knowledge, Question 9 has been newly added.
15	Analysis of financial statements	• Common defects in the financial statements has been removed • Illustrations, case studies and questions (given in Test Your Knowledge) based on accounting standards have been removed
17	Corporate Social Responsibility	• In Point C of Para 4.2, 'Role of Board' has been amended • Chart on section 135 has been amended • Para 5.3 has been amended.

CONTENTS

DETAILED CONTENTS: MODULE – 4

CHAPTER 13-BUSINESS COMBINATION AND CORPORATE RESTRUCTURING

Contents:

CHAPTER 14 –CONSOLIDATED FINANCIAL STATEMENTS

Contents:

Unit 1: Introduction to Consolidated Financial Statements

CHAPTER 15 – ANALYSIS OF FINANCIAL STATEMENTS

Contents:

CHAPTER 16-INTEGRATED REPORTING

Contents:

CHAPTER 17- CORPORATE SOCIAL RESPONSIBIILITY

Contents:

CHAPTER 13

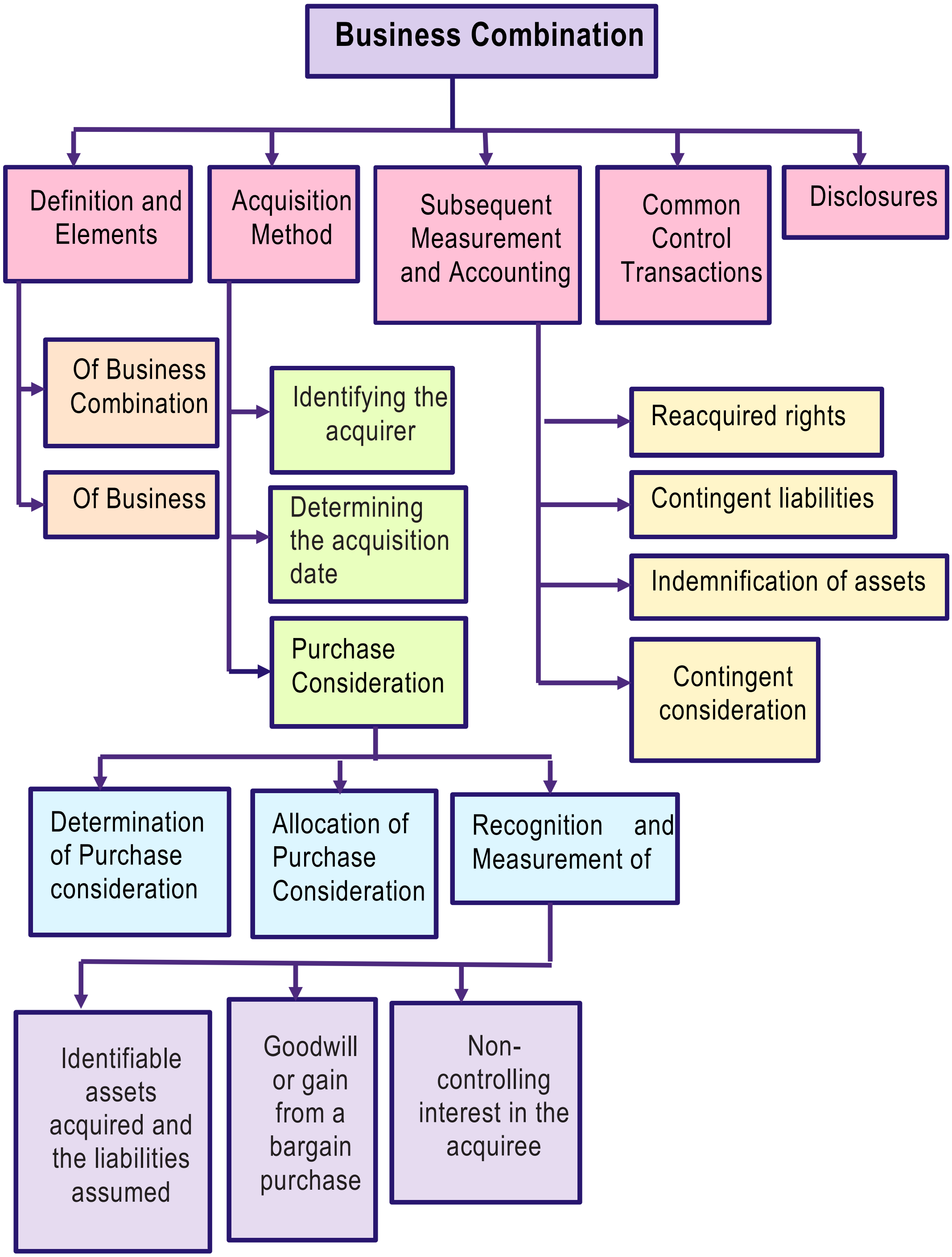
BUSINESS COMBINATION AND CORPORATE RESTRUCTURING

LEARNING OUTCOMES

After studying this chapter, you would be able to:

- Understand various terms used in Ind AS 103 "Business Combination"
- Examine the key differences between Ind AS 103 and Existing Accounting Standards
- Identify the acquiring enterprises
- Determine the acquisition date, purchase consideration under various situations and contingent consideration
- Allocate the purchase price
- Recognize the assets and liabilities of the acquired entity
- Examine the measurement principles
- Calculate the goodwill or bargain purchase
- Evaluate contingent payments to employee shareholders and acquirer share-based payment awards exchanged for awards held by the acquiree's employees
- Integrate subsequent measurement and accounting principles for reacquired rights, contingent liabilities, indemnification assets and contingent consideration
- Appraise the disclosure requirements in case of Business Combination
- Account for distribution of non-cash assets to owners as dividend in accordance with Appendix A Distribution of Non-Cash Assets to Owners of Ind AS 10 Events after the Reporting Period.

CHAPTER OVERVIEW



1. INTRODUCTION

Restructuring is the corporate management term for the act of reorganizing the legal, ownership, operational, or other structures of a company for the purpose of making it more profitable, or better organized for its present needs. Alternate reasons for restructuring include a change of ownership or ownership structure, demerger, or a response to a crisis or major change in the business such as bankruptcy, repositioning, or buyout. Restructuring may also be described as corporate restructuring, debt restructuring and financial restructuring.

Corporates are now restructuring and repositioning their folios to meet the challenges and seize opportunities thrown open by the multilateral trade agenda and emergence of the World Trade Organisation (WTO).

Most of the diversified multi-product companies are restructuring their corporate operations into more homogenous units to achieve synergy in operations. This entails transfer of business units from one company to the other or breaking up of a large group into smaller ones. On the other hand, smaller companies are forming alliances and joint ventures for their survival and growth. The exercise involves strategic planning to cope with the complex changes in the ownership and control and comply with a variety of business laws.

The underlying object of corporate restructuring is efficient and competitive business operations by increasing the market share, brand power and synergies. In the emerging scenario, joint ventures, alliances, mergers, amalgamations and takeovers are becoming the easiest and quickest way to expand capacities and acquire dominance over the market.

While asset and capital restructuring can be termed as external, organisational restructuring may be referred to as internal; this is based on the significance and impact of the restructuring process on a company's internal or external stakeholders.

2. MERGERS AND DEMERGERS

2.1 Mergers

It is a legal process by which two or more companies are joined together to form a new entity or one or more companies are absorbed by another company and as a consequence the amalgamating company loses its existence and its shareholders become the shareholders of the new or amalgamated company.

2.2 Demergers

Demerger is an arrangement whereby some part /undertaking of one company is transferred to another company which operates completely separate from the original company. Shareholders of the original company are usually given an equivalent stake of ownership in the new company.

Demerger is undertaken basically for following reasons:

- The first as an exercise in corporate restructuring and

- the second is to give effect to kind of family partitions in case of family owned enterprises.
- A demerger is also done to help each of the segments operate more smoothly, as they can now focus on a more specific task.

3. BUSINESS COMBINATION AS PER IND AS 103 'BUSINESS COMBINATION'

The necessity of a standard on Business Combination in India assumes importance considering the fact that Indian companies are increasingly stretching their business in foreign countries for best-fit business combinations. Presently in India, Accounting Standard (AS) 14 'Accounting for Amalgamation' lays out specific treatment for Amalgamation and AS 21, 'Consolidated Financial Statements' are applied for consolidation. However, it is not matching the global reporting standards requirements.

After convergence of IFRS as Ind AS, Ind AS 103 which is in line with IFRS 3 takes care of the global requirements in case of business combinations worldwide.

A **business combination** is a transaction in which the acquirer obtains control of another business (the acquiree).

The term **'business'** is defined as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

Business combinations are most common form of business transaction through which companies grow in size rather than organic activities.

Business combination or acquisition is different from asset acquisition. The following are the key differences in accounting of an asset acquisition and a business combination:

Particulars	Business Combination	Acquisition of group of assets under Ind AS
Intangible assets, including goodwill	Intangible assets are recognised at fair value, if they are separately identifiable. Goodwill is recognised as a separate asset.	Intangible assets acquired as part of a group of assets would be recognised and measured based on an allocation of the overall cost of the transaction with reference to their relative fair values. No goodwill would be recognised.
Transaction Costs	In a business combination, acquisition-related costs (including stamp duty) are expensed in the period in which such costs are incurred and are	Transaction costs are capitalised as a component of the cost of the assets acquired.

	not included as part of the consideration transferred.	
Deferred Tax Accounting	Deferred taxes are recorded on temporary differences of assets acquired (other than goodwill) and liabilities assumed in a business combination.	Ind AS prohibits recognition of deferred taxes for temporary differences that arise upon initial recognition of an asset or liability in a transaction that (i) is not a business combination and (ii) at the time of the transaction, affects neither accounting nor taxable income. [Ind AS 12 paragraph 15]. Accordingly, no deferred taxes are recognised for temporary differences on asset acquisitions (on initial recognition).
Situations where the fair value of the assets acquired and Liabilities assumed exceeds the fair value of consideration Transferred (referred to as gain on bargain purchases)	If the fair value of the assets acquired and liabilities assumed exceeds the fair value of the consideration transferred (plus the amount of non-controlling interest and the fair value of the acquirer's previously held equity interests in the acquiree), a gain is recognised by the acquirer in other comprehensive income and accumulated in capital reserve.	The assets acquired and liabilities assumed are measured using an allocation of the fair value of consideration transferred based upon relative fair values. As a result, no gain is recognised for a bargain purchase.

Illustration 1: Asset acquisition

An entity acquires an equipment and a patent in exchange for ₹ 1,000 crore cash and land. The fair value of the land is ₹ 400 crore and its carrying value is ₹ 100 crore. The fair values of the equipment and patent are estimated to be ₹ 500 crore and ₹ 1,000 crore, respectively. The equipment and patent relate to a product that has just recently been commercialised. The market for this product is still developing.

Assume the entity incurred no transaction costs. For ease of convenience, the tax consequences on the gain have been ignored. How should the transaction be accounted for?

Solution

As per paragraph 2(b) of Ind AS 103, the standard does not apply to “the acquisition of an asset or a group of assets that does not constitute a business. In such cases the acquirer shall identify and recognise the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, intangible assets in Ind AS 38, Intangible Assets) and liabilities assumed. The cost of the group shall be allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase. Such a transaction or event does not give rise to goodwill". In the given case, the acquisition of equipment and patent does not represent acquisition of a business.

The cost of the asset acquisition is determined based on the fair value of the assets given, unless the fair value of the assets received is more reliably determinable. In the given case, the fair value measurement of the land appears more reliable than the fair value estimate of the equipment and patent. Thus, the entity should record the acquisition of the equipment and patent as ₹ 1,400 crore (the total fair value of the consideration transferred).

Thus, the fair value of the consideration given, i.e., ₹ 1,400 crore is allocated to the individual assets acquired based on their relative estimated fair values. The entity should record a gain of ₹ 300 crore for the difference between the fair value and carrying value of the land.

The equipment is recorded at its relative fair value ((₹ 500 / ₹ 1,500) × ₹ 1,400 = ₹ 467 crore).

The patent is recorded at its relative fair value ((₹ 1,000 / ₹ 1,500) × ₹ 1,400 = ₹ 933 Crore).

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4. SCOPE UNDER IND AS 103

This Indian Accounting Standard applies to a transaction or other event that meets the definition of a business combination. This Indian Accounting Standard does not apply to:

(a) the formation of a joint venture.

(b) the acquisition of an asset or a group of assets that does not constitute a business i.e. it is an asset acquisition.

5. DEFINITION OF BUSINESS COMBINATION

Under Ind AS 103, Business combination occurs when an entity obtains **control** of a **business** by acquiring net assets or acquiring its significant equity interest. An entity can obtain control of a business by contract only in which case the acquirer would neither have acquired net assets nor equity interest. In such a case, while preparing balance sheet, controlling interest would be zero and non-controlling interest will be 100%.

- As such, two elements are required for a transaction to be a business combination under Ind AS 103:
  - ➢ the acquirer obtains control of an acquiree ("control" as defined in Ind AS 110); and
  - ➢ the acquiree is a business
- An acquirer might obtain control of an acquiree in a variety of ways, for example:
  - ➢ by transferring cash, cash equivalents or other assets (including net assets that constitute a business);
  - ➢ by incurring liabilities;

- by issuing equity interests;
- by providing more than one type of consideration; or
- without transferring consideration, including by contract alone.

- A business combination may be structured in a variety of ways for legal, taxation or other reasons, which include but are not limited to:
  - one or more businesses become subsidiaries of an acquirer or the net assets of one or more businesses are legally merged into the acquirer;
  - one combining entity transfers its net assets, or its owners transfer their equity interests, to another combining entity or its owners;
  - all of the combining entities transfer their net assets, or the owners of those entities transfer their equity interests, to a newly formed entity (sometimes referred to as a roll-up or put-together transaction); or
  - a group of former owners of one of the combining entities obtains control of the combined entity.

6. DEFINITION AND ELEMENTS OF BUSINESS

6.1 Definition of Business

As per paragraph B7 of the application guidance of Ind AS 103, a business consists of inputs and processes applied to those inputs that have the ability to create outputs. Although businesses usually have outputs, outputs are not required for an integrated set to qualify as a business.

Analysis: Ind AS 103 defines business as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

6.2 Elements of Business

The three elements of a business are defined as follows:

(a) **Input**: Any economic resource that creates, or has the ability to create, outputs when one or more processes are applied to it.

> **Example:**
>
> Non-current assets (including intangible assets or rights to use non-current assets), intellectual property, the ability to obtain access to necessary materials or rights and employees.

(b) **Process**: Any system, standard, protocol, convention or rule that when applied to an input or inputs, creates or has the ability to create outputs.

Example:

Strategic management processes, operational processes and resource management processes.

These processes typically are documented, but an organised workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. (Accounting, billing, payroll and other administrative systems typically are not processes used to create outputs.)

(c) **Output**: The result of inputs and processes applied to those inputs that provide or have the ability to provide a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

Example : Simple-business combination

Company X is a liquor manufacturer and has traded for a number of years. The company produces a wide variety of liquor and employs a workforce of machine operators, testers, and other operational, marketing and administrative staff. It owns and operates a factory, warehouse and machinery and holds raw material inventory and finished products.

On 1st January, 20X1, Company Y pays USD 80 million to acquire 100% of the ordinary voting shares of Company X. No other type of shares has been issued by Company X. On the same day, the four main executive directors of Company Y take on the same roles in Company X.

In this case, it is clear that Company X is a business. It operates a trade with a variety of assets that are used by its employees in a number of related activities. These assets and activities are necessarily integrated in order to create and sell the company's products. Company X obtains control on 1st January, 20X1 by acquiring 100% of the voting rights.

The application of the definition is less clear in situations as illustrated in the following examples:

Example : Investment in a development stage entity

Company D is a development stage entity that has not started revenue-generating operations. The workforce consists mainly of research engineers who are developing a new technology that has a pending patent application. Negotiations to license this technology to a number of customers are at an advanced stage. Company D requires additional funding to complete development work and commence planned commercial production.

The value of the identifiable net assets in Company D is ₹ 750 million. Company A pays ₹ 600 million in exchange for 60% of the equity of Company D (a controlling interest).

Although Company D is not yet earning revenues (an example of 'outputs') there are a number of indicators that it has a sufficiently integrated set of activities and assets that are capable of being managed to produce a return for investors. In particular, Company D:

- employs specialist engineers developing the know-how and design specifications of the technology.
- is pursuing a viable plan to complete the development work and commence production.

- has identified and will be able to access customers willing to buy the outputs.

In addition, Company A has paid a premium (or goodwill) for its 60% interest. In the absence of evidence to the contrary, Company D is presumed to be a business.

Example : Acquisition of an entity holding investment properties

Company A acquires 100% of the equity and voting rights of Company P, a subsidiary of a property investment group. Company P owns three investment properties. The properties are single-tenant industrial warehouses subject to long-term leases. The leases oblige Company P to provide basic maintenance and security services, which have been outsourced to third party contractors. The administration of Company P's leases was carried out by an employee of its former parent company on a part-time basis but this individual does not transfer to the new owner.

In most cases, an asset or group of assets and liabilities that are capable of generating revenues, combined with all or many of the activities necessary to earn those revenues, would constitute a business. However, investment property is a specific case in which earning a return for investors is a defining characteristic of the asset. Accordingly, revenue generation and activities that are specific and ancillary to an investment property and its tenancy agreements should therefore be given a lower 'weighting' in assessing whether the acquiree is a business. In our view the purchase of investment property with tenants and services that are purely ancillary to the property and its tenancy agreements should generally be accounted for as an asset purchase.

Example : Acquisition of an entity holding investment properties

Company A acquires 100% of the equity and voting rights of Company Q, which owns three investment properties. The properties are multi-tenant residential condominiums subject to short-term rental agreements that oblige Company Q to provide substantial maintenance and security services, which are outsourced with specialist providers. Company Q has five employees who deal directly with the tenants and with the outsourced contractors to resolve any non-routine security or maintenance requirements. These employees are involved in a variety of lease management tasks (eg identification and selection of tenants; lease negotiation and rent reviews) and marketing activities to maximise the quality of tenants and the rental income.

In this case, Company Q consists of a group of revenue-generating assets, together with employees and activities that clearly go beyond activities ancillary to the properties and their tenancy agreements. The assets and activities are clearly integrated so Company Q is considered a business.

Example : Seller retains some activities and assets

Company S is a manufacturer of a wide range of products. The company's payroll and accounting system is managed as a separate cost centre, supporting all the operating segments and the head office functions.

Company A agrees to acquire the trade, assets, liabilities and workforce of the operating segments of Company S but does not acquire the payroll and accounting cost centre or any head office functions. Company A is a competitor of Company S.

In this case, the activities and assets within the operating segments are capable of being managed as a business and so Company A accounts for the acquisition as a business combination. The payroll and accounting cost centre and administrative head office functions are typically not used to create outputs and so are generally not considered an essential element in the assessment of whether an integrated set of activities and assets is a business.

Example : Acquisition of a shell company

Company A is a property development company with a number of subsidiary companies, each of which holds a single development. After completion of the development, Company A sells its equity investment because the applicable tax rate is lower than that applicable to the sale of the underlying property.

Company A is planning to start the development of a large new retail complex. Rather than incorporating a new company, Company A acquires the entire share capital of a 'shell' company.

The shell company does not contain an integrated set of activities and assets and so does not constitute a business. Consequently, Company A should account for the purchase of the shell company in the same way as the incorporation of a new subsidiary. In the consolidated financial statements, any costs incurred will be accounted for in accordance with their nature and applicable Ind AS. No goodwill is recognised.

Point to remember

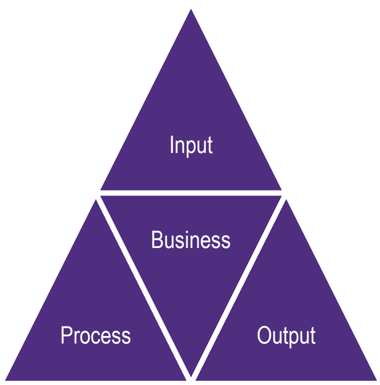

Illustration 2

Company A is a pharmaceutical company. Since inception, the Company had been conducting in-house research and development activities through its skilled workforce and recently obtained an intellectual property right (IPR) in the form of patents over certain drugs. The Company's has a production plant that has recently obtained regulatory approvals. However, the Company has not earned any revenue so far and does not have any customer contracts for sale of goods. Company B acquires Company A.

Does Company A constitute a business in accordance with Ind AS 103?

Solution

The definition of business requires existence of inputs and processes. In this case, the skilled workforce, manufacturing plant and IPR, along with strategic and operational processes constitutes the inputs and processes in line with the requirements of Ind AS 103.

When the said inputs and processes are applied as an integrated set, the Company A will be capable of producing outputs; the fact that the Company A currently does not have revenue is not relevant to the analysis of the definition of business under Ind AS 103. Basis this and presuming that Company A would have been able to obtain access to customers that will purchase the outputs, the present case can be said to constitute a business as per Ind AS 103.

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Illustration 3

Modifying the above illustration, if Company A had revenue contracts and a sales force, such that Company B acquires all the inputs and processes other than the sales force, then whether the definition of the business is met in accordance with Ind AS 103?

Solution

Though the sales force has not been taken over, however, if the missing inputs (i.e., sales force) can be easily replicated or obtained by the market participant to generate output, it may be concluded that Company A has acquired business. Further, if Company B is also into similar line of business, then the existing sales force of Company B may also be relevant to mitigate the missing input. As such, the definition of business is met in accordance with Ind AS 103.

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7. THE ACQUISITION METHOD

The following key steps are involved in the acquisition accounting for business combinations:

Step 1: Identifying the acquirer.

Step 2: Determining the acquisition date.

Step 3: Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree; and

Step 4: Recognising and measuring goodwill or a gain from a bargain purchase.

8. IDENTIFYING ACQUIRING ENTERPRISE

8.1 The Acquiring Enterprise

All business combination within the scope of Ind AS 103 are accounted under the acquisition method (also known as purchase method). In order to apply the purchase method, the parties involved has to identify the acquirer i.e the entity that obtains the control of another entity. The another entity on whom the control is established is termed as acquiree. This is because the acquiree's assets and liabilities is what is accounted as per the recognition and measurement principles of the standard.

The acquiring enterprise is the enterprise which obtains control and the determination of control is as per the guidance given in Ind AS 110. It may so happen that guidance in Ind AS 110 does not clearly indicate which of the combining entity is the acquirer. In such a case, Ind AS 103 provides additional guidance on identifying the acquirer.

As per Ind AS 110 'Consolidated Financial Statements', an investor controls an investee if and only if the investor has all the following:

(a) power over the investee;

(b) exposure, or rights, to variable returns from its involvement with the investee; and

(c) the ability to use its power over the investee to affect the amount of the investor's returns.

The above definition is very wide and control assessment does not depend only on voting rights instead it depends on the following as well:

- Potential voting rights;
- Rights of non-controlling shareholders; and
- Other contractual right of the investor if those are substantive in nature.

Control assessment has been discussed in detail in the chapter of Consolidated Financial Statements. One example on potential voting rights and its implication on assessment of control is provided below for the students to understand the concept of control.

In order to ascertain control do not look at the voting rights only. Evaluate other factors also like board control, potential voting rights etc.

Indicator of Control		
More than 50% Voting rights	Power to appoint and remove board of directors	Investor have currently excersiable potential voting rights

Illustration 4: Potential voting rights

Company P Ltd., a manufacturer of textile products, acquires 40,000 of the equity shares of Company X (a manufacturer of complementary products) out of 1,00,000 shares in issue. As part of the same agreement, Company P purchases an option to acquire an additional 25,000 shares. The option is exercisable at any time in the next 12 months. The exercise price includes a small premium to the market price at the transaction date.

After the above transaction, the shareholdings of Company P's two other original shareholders are 35,000 and 25,000. Each of these shareholders also has currently exercisable options to acquire 2,000 additional shares. Assess whether control is acquired by Company P.

Solution

In assessing whether it has obtained control over Company X, Company P should consider not only the 40,000 shares it owns but also its option to acquire another 25,000 shares (a so-called potential voting right). In this assessment, the specific terms and conditions of the option agreement and other factors are considered:

- the options are currently exercisable and there are no other required conditions before such options can be exercised
- if exercised, these options would increase Company P's ownership to a controlling interest of over 50% before considering other shareholders' potential voting rights (65,000 shares out of a total of 1,25,000 shares)
- although other shareholders also have potential voting rights, if all options are exercised Company P will still own a majority (65,000 shares out of 1,29,000 shares)
- the premium included in the exercise price makes the options out-of-the-money. However, the fact that the premium is small and the options could confer majority ownership indicates that the potential voting rights have economic substance.

By considering all the above factors, Company P concludes that with the acquisition of the 40,000 shares together with the potential voting rights, it has obtained control of Company X.

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8.2 Acquisitions through payment of cash or incurring of liability

In a business combination effected primarily by transferring cash or other assets or by incurring liabilities, the acquirer is usually the entity that transfers the cash or other assets or incurs the liabilities.

8.3 Acquisitions through issue of equity instrument

In a business combination effected primarily by exchanging equity interests, the acquirer is usually the entity that issues its equity interests. However, in some business combinations, commonly called 'reverse acquisitions', the issuing entity is the acquiree. Reverse acquisition has been dealt in a separate section of this chapter.

Other pertinent facts and circumstances shall also be considered in identifying the acquirer in a business combination effected by exchanging equity interests, including:

a) *The relative voting rights in the combined entity after the business combination:* The acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity. In determining which group of owners retains or receives the largest portion of the voting rights, an entity shall consider the existence of any unusual or special voting arrangements and options, warrants or convertible securities.

b) *The existence of a large minority voting interest in the combined entity if no other owner or organised group of owners has a significant voting interest*—The acquirer is usually the combining entity whose single owner or organised group of owners holds the largest minority voting interest in the combined entity.

c) *The composition of the governing body of the combined entity*—The acquirer is usually the combining entity whose owners have the ability to elect or appoint or to remove a majority of the members of the governing body of the combined entity.

d) *The composition of the senior management of the combined entity*—The acquirer is usually the combining entity whose (former) management dominates the management of the combined entity.

e) *The terms of the exchange of equity interests*—The acquirer is usually the combining entity that pays a premium over the pre-combination fair value of the equity interests of the other combining entity or entities.

f) *The acquirer is usually the combining entity* whose relative size (measured in, for example, assets, revenues or profit) is significantly greater than that of the other combining entity or entities. In a business combination involving more than two entities, determining the acquirer shall include a consideration of, among other things, which of the combining entities initiated the combination, as well as the relative size of the combining entities.

Example :

Company A and Company B operate in power industry and both entities are operating entities. Company A has much larger scale of operations than Company B. Company B merges with Company A such that the shareholders of Company B would receive 1 equity share of Company A for every 1 share held in Company B. Such issue of shares would comprise 20% of the issued share capital of the combined entity. After discharge of purchase consideration, the pre-merger shareholders of Company A hold 80% of the capital in Company A.

In this transaction, Company A is the acquirer for the purposes of accounting for business combination as per Ind AS 103. This is because, by merging the entire shareholding of Company B, Company A has acquired control over Company B. Further, the shareholders of erstwhile Company B do not obtain control over Company A on account of shares received as part of purchase consideration, as they hold only 20% of the paid-up capital of Company A.

Example :

Company A and Company B operate in power industry and both entities are operating entities. Company A has much smaller scale of operations than Company B. Company B merges Company A such that the shareholders of Company B would receive 10 equity share of Company A for every 1 share held in Company B. Such issue of shares would comprise 70% of the issued share capital of the combined entity. After discharge of purchase consideration, the pre-merger shareholders of Company A hold 30% of capital of Company A. Post-acquisition, the management of Company B would manage the operations of the combined entity.

In this transaction, Company B is the acquirer for the purposes of accounting for business combination as per Ind AS 103. This is because, after merger, the shareholders of erstwhile Company B would have a controlling interest and management of the combined entity. As such, in substance, Company B has acquired control over Company A.

It is important to note that the Company B would be considered as an acquirer for accounting purposes only (i.e., accounting acquirer). For legal purposes as well as for reporting purposes, it is the Company A that would be considered as an acquirer (i.e., legal acquirer).

Appropriate identification of an acquirer is relevant, as the net assets of the accounting acquiree (rather than that of the accounting acquirer) are recognised at fair value.

Illustration 5

ABC Ltd. incorporated a company Super Ltd. to acquire 100% shares of another entity Focus Ltd. (and therefore to obtain control of the Focus Ltd.). To fund the purchase, Super Ltd. acquired a loan from XYZ Bank at commercial interest rates. The loan funds are used by Super Ltd. to acquire entire voting shares of Focus Ltd. at fair value in an orderly transaction. Post the acquisition, Super Ltd. has the ability to elect or appoint or to remove a majority of the members of the governing body of the Focus Ltd. and also Super Ltd.'s management is in a power where it will be able to dominate the management of the Focus Ltd. Can Super Ltd. be identified as the acquirer in this business combination?

Solution

Paragraph 6 of Ind AS 103 states that for each business combination, one of the combining entities shall be identified as the acquirer.

While paragraph 7 states that the guidance in Ind AS 110 shall be used to identify the acquirer that is the entity that obtains control of another entity called the acquiree. If a business combination has occurred but applying the guidance in Ind AS 110 does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs B14–B18 of Ind AS 103 shall be considered in making that determination.

Further, paragraph B15 provides that, in a business combination effected primarily by exchanging equity interests, the acquirer is usually the entity that issues its equity interests. However, in some business combinations, commonly called 'reverse acquisitions', the issuing entity is the acquiree. Other pertinent facts and circumstances shall also be considered in identifying the acquirer in a business combination effected by exchanging equity interests, including:

(a) **The relative voting rights in the combined entity after the business combination:** The acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity. In determining which group of owners retains or receives the largest portion of the voting rights, an entity shall consider the existence of any unusual or special voting arrangements and options, warrants or convertible securities.

(b) **The existence of a large minority voting interest in the combined entity if no other owner or organised group of owners has a significant voting interest:** The acquirer is usually the combining entity whose single owner or organised group of owners holds the largest minority voting interest in the combined entity.

(c) **The composition of the governing body of the combined entity:** The acquirer is usually the combining entity whose owners have the ability to elect or appoint or to remove a majority of the members of the governing body of the combined entity.

(d) **The composition of the senior management of the combined entity:** The acquirer is usually the combining entity whose (former) management dominates the management of the combined entity.

(e) **The terms of the exchange of equity interests:** The acquirer is usually the combining entity that pays a premium over the pre-combination fair value of the equity interests of the other combining entity or entities.

The key drivers of the accounting are identifying the party on whose behalf the new entity has been formed and identifying the business acquired. In this scenario, as Super Ltd. has the ability to elect or appoint or to remove a majority of the members of the governing body of the Focus Ltd. and has the ability to dominate the management of the Focus Ltd. Accordingly, Super Ltd. will be identified as the acquirer unless there are conditions to conclude to the contrary.

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8.4 Acquisition involving Shell Company and Reverse Acquisition

A reverse acquisition occurs when the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes. The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition. For example, reverse acquisitions sometimes occur when a private operating entity wants to become a public entity but does not want to register its equity shares. To accomplish that, the private entity will arrange for a public entity to acquire its equity interests in exchange for the equity interests of the public entity. In this example, the public entity is the **legal acquirer** because it issued its equity interests, and the private entity is the **legal acquiree** because its equity interests were acquired. However, application of the guidance given in above paragraph results in identifying:

a) the public entity as the **acquiree** for accounting purposes (the accounting acquiree); and

b) the private entity as the **acquirer** for accounting purposes (the accounting acquirer).

The accounting acquiree must meet the definition of a business for the transaction to be accounted for as a reverse acquisition, and all of the recognition and measurement principles of Ind AS 103, including the requirement to recognise goodwill, will apply.

Example : New parent pays cash to effect a business combination

Company A decided to spin-off two of its existing businesses (currently housed in two separate entities, Company B and Company C). To facilitate the spin-off, Company A incorporates a new entity (Company D) with nominal equity and appoints independent directors to the board of Company D. Company D signs an agreement to purchase Companies B and C in cash, conditional on obtaining sufficient funding. To fund these acquisitions, Company D issues a prospectus offering to issue shares for cash.

At the conclusion of the transaction, Company D has owned 99% by the new investors with Company A retaining only a 1% non-controlling interest.

In this situation, a set of new investors paid cash to obtain control of Company D in an arm's length transaction. Company D is then used to effect the acquisition of 100% ownership of Companies B and C by paying cash. Company A relinquishes its control of Companies B and C to the new owners of Company D.

Although Company D is a newly formed entity, Company D is identified as the acquirer not only because it paid cash but also because the new owners of Company D have obtained control of Companies B and C from Company A.

Identification of the acquiring enterprise is very critical and the accounting may change significantly if the accounting acquirer is different than legal acquirer.

9. DETERMINING THE ACQUISITION DATE

The acquirer shall identify the acquisition date, which is the date on which it obtains control of the acquiree.

The date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree—the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date. For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date. An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.

The acquisition date is a very important step in the business combination accounting because it determines when the acquirer recognises and measures the consideration, the assets acquired and liabilities assumed. The acquiree's results are consolidated from this date. The acquisition date materially impacts the overall acquisition accounting, including post-combination earnings.

The acquisition date is often readily apparent from the structure of the business combinations and the terms of the sale and purchase agreement (if applicable) but this is not always the case.

Acquisition date will be the date on which the acquirer obtains control.

Example

Company A acquired 80% equity interest in Company B for cash consideration. The relevant dates are as under:

✓ Date of shareholder agreement	1st June, 20X1
✓ Appointed date as per shareholder agreement	1st April, 20X1
✓ Date of obtaining control over the board representation	1st July, 20X1
✓ Date of payment of consideration	15th July, 20X1
✓ Date of transfer of shares to Company A	1st August, 20X1

In this case, as the control over financial and operating policies are acquired through obtaining board representation on 1st July, 20X1, it is this date that is considered as the acquisition date. It may be noted that the appointed date as per the agreement is not considered as the acquisition date, as the Company A did not have control over Company B as at that date.

Illustration 6

Can an acquiring entity account for a business combination based on a signed non-binding letter of intent where the exchange of consideration and other conditions are expected to be completed with 2 months?

Solution

No. as per the requirement of the standard a non- binding Letter of Intent (LOI) does not effectively transfer control and hence this cannot be considered as the basis for determining the acquisition date.

*****

Illustration 7

On 1st April, X Ltd. agrees to acquire the share of B Ltd. in an all equity deal. As per the binding agreement X Ltd. will get the effective control on 1st April. However, the consideration will be paid only when the shareholders' approval is received. The shareholders meeting is scheduled to happen on 30th April. If the shareholders' approval is not received for issue of new shares, then the consideration will be settled in cash. What is the acquisition date?

Solution

The acquisition date in the above case is 1st April. This is because, in the above scenario, even if the shareholders don't approve the shares, consideration will be settled through payment of cash.

*****

Illustration 8 : Business Combination without a Court approved scheme

ABC Ltd. acquired all the shares of XYZ Ltd. The negotiations had commenced on 1st January, 20X1 and the agreement was finalised on 1st March, 20X1. While ABC Ltd. obtains the power to control XYZ Ltd.'s operations on 1st March, 20X1, the agreement states that the acquisition is *effective from 1st January, 20X1 and that ABC Ltd. is entitled to all profits after that date. In addition, the purchase price is based on XYZ Ltd.'s net asset position as at 1st January, 20X1. What is the date of acquisition?*

Solution

Paragraph 8 of Ind AS 103 provides that acquisition date is the date on which the acquirer obtains control of the acquiree.

Further paragraphs 6 and 7 of Ind AS 110, Consolidated Financial Statements, inter alia, state that an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Thus, an investor controls an investee if and only if the investor has all the following:

(a) power over the investee;

(b) exposure, or rights, to variable returns from its involvement with the investee; and

(c) the ability to use its power over the investee to affect the amount of the investor's returns.

Further, paragraph 9 of Ind AS 103 clarifies that the date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree—the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date.

Therefore, in this case, notwithstanding that the price is based on the net assets at 1st January, 20X1 and that XYZ Ltd.'s shareholders do not receive any dividends after that date, the date of acquisition for accounting purposes will be 1st March, 20X1. It is only on 1st March, 20X1 and not 1st January, 20X1, that ABC Ltd. has the power to direct the relevant activities of XYZ Ltd. so as to affect its returns from its involvement with XYZ Ltd. Accordingly, the date of acquisition is 1st March, 20X1.

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Illustration 9 : Acquisition date- Regulatory approval

ABC Ltd. and XYZ Ltd. are manufacturers of rubber components for a particular type of equipment. ABC Ltd. makes a bid for XYZ Ltd.'s business and the Competition Commission of India (CCI) announces that the proposed transaction is to be scrutinised to ensure that competition laws are not breached. Even though the contracts are made subject to the approval of the CCI, ABC Ltd. and XYZ Ltd. mutually agree the terms of the acquisition and the purchase price before competition authority clearance is obtained. Can the acquisition date in this situation be the date on which ABC Ltd. and XYZ Ltd. agree the terms even though the approval of CCI is awaited (Assume that the approval of CCI is substantive)?

Solution

Paragraph 8 of Ind AS 103 provides that acquisition date is the date on which the acquirer obtains control of the acquiree.

Further, paragraph 9 of Ind AS 103 clarifies that the date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree—the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date.

For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date. An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.

Since CCI approval is a substantive approval for ABC Ltd. to acquire control of XYZ Ltd.'s operations, the date of acquisition cannot be earlier than the date on which approval is obtained from CCI. This is pertinent given that the approval from CCI is considered to be a substantive process and accordingly, the acquisition is considered to be completed only on receipt of such approval.

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10. STEP ACQUISITIONS

In the case an entity acquires an entity step by step through series of purchase then the acquisition date will be the date on which the acquirer obtains control. Till the time the control is obtained the Investment will be accounted as per the requirements of other Ind AS 109, if the investments are covered under that standard or as per Ind AS 28, if the investments are in Associates or Joint Ventures.

In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss or other comprehensive income, as appropriate.

In prior reporting periods, the acquirer may have recognised changes in the value of its equity interest in the acquiree in other comprehensive income. If so, the amount that was recognised in other comprehensive income shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest.

11. DETERMINATION OF THE PURCHASE CONSIDERATION

The consideration transferred in a business combination shall be measured at fair value, which shall be calculated as the total of the acquisition-date fair values of the assets (including cash) transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree and the equity interests issued by the acquirer. Examples of potential forms of consideration include cash, other assets, a business or a subsidiary of the acquirer, *contingent consideration*, ordinary or preference equity instruments, options, warrants and member interests of *mutual entities*.

Exception to the fair value in determination of Purchase consideration

However, any portion of the acquirer's share-based payment awards exchanged for awards held by the acquiree's employees that is included in consideration transferred in the business combination shall be measured in accordance with the requirements of Ind AS 102, Share Based payments.

The consideration transferred may include assets or liabilities of the acquirer that have carrying amounts that differ from their fair values at the acquisition date (for example, non-monetary assets or a business of the acquirer). If so, the acquirer shall remeasure the transferred assets or liabilities to their fair values as of the acquisition date and recognise the resulting gains or losses, if any, in profit or loss.

This means that if the acquirer has transferred a land as a part of the business combination arrangement to the owners of the acquiree then the fair value of the land will be considered in determining the fair value of the consideration. Consequently, the land will be de-recognised in the financial statements of the acquirer and the difference between the carrying amount of the land and the fair value considered for purchase consideration will be recorded in profit and loss.

However, sometimes the transferred assets or liabilities remain within the combined entity after the business combination (for example, because the assets or liabilities were transferred to the acquiree rather than to its former owners), and the acquirer therefore retains control of them. In that situation, the acquirer shall measure those assets and liabilities at their carrying amounts immediately before the acquisition date and shall not recognise a gain or loss in profit or loss on assets or liabilities it controls both before and after the business combination.

11.1 A Business Combination achieved in Stages (Step Acquisition)

An acquirer sometimes obtains control of an acquiree in which it held an equity interest immediately before the acquisition date.

Example :

On 31st December 20X1, Entity A holds a 35 per cent non-controlling equity interest in Entity B. On that date, Entity A purchases an additional 40 per cent interest in Entity B, which gives it control of Entity B. This transaction is referred as a business combination achieved in stages, sometimes also referred to as a step acquisition.

In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss. In prior reporting periods, the acquirer may have recognised changes in the value of its equity interest in the acquiree in other comprehensive income. As per Ind AS 109 or Ind AS 27, an entity can elect to measure investments in equity instruments at fair value through other comprehensive income. However, once elected all gains and losses on that investment even on sale is recognized in OCI. Therefore, if the investment is designated as fair value through OCI, the resulting gain or loss, if any, will be recognized in OCI.

When a party to a joint operation, obtains control of a joint operation business, the transaction will be considered as a business combination achieved in stages. The acquirer should re-measure its previously held interest in the joint operation at fair value at the acquisition date.

Illustration 10

On 1st April, 20X1, PQR Ltd. acquired 30% of the voting ordinary shares of XYZ Ltd. for ₹ 8,000 crore. PQR Ltd. accounts its investment in XYZ Ltd. using equity method as prescribed under Ind AS 28. At 31st March, 20X2, PQR Ltd. recognised its share of the net asset changes of XYZ Ltd. using equity accounting as follows:

	(₹ in crore)
Share of profit or loss	*700*
Share of exchange difference in OCI	*100*
Share of revaluation reserve of PPE in OCI	*50*

The carrying amount of the investment in the associate on 31st March, 20X2 was therefore ₹ 8,850 crore (8,000 + 700 + 100 + 50).

On 1st April, 20X2, PQR Ltd. acquired the remaining 70% of XYZ Ltd. for cash ₹ 25,000 crore. The following additional information is relevant at that date:

	(₹ in crore)
Fair value of the 30% interest already owned	*9,000*
Fair value of XYZ's identifiable net assets	*30,000*

How should such business combination be accounted for?

Solution

Paragraph 42 of Ind AS 103 provides that in a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss or other comprehensive income, as appropriate. In prior reporting periods, the acquirer may have recognized changes in the value of its equity interest in the acquiree in other comprehensive income. If so, the amount that was recognised in other comprehensive income shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest.

Applying the above, PQR Ltd. records the following entry in its consolidated financial statements:

		(₹ in crore)	
		Debit	**Credit**
Identifiable net assets of XYZ Ltd.	Dr.	30,000	
Goodwill (W.N.1)	Dr.	4,000	
Foreign currency translation reserve	Dr.	100	
PPE revaluation reserve	Dr.	50	
To Cash			25,000
To Investment in associate -XYZ Ltd.			8,850
To Retained earnings (W.N.2)			50

To Gain on previously held interest in XYZ recognised in Profit or loss (W.N.3)		250
(To recognise acquisition of XYZ Ltd.)		

Working Notes:

1. Calculation of Goodwill

	₹ in crore
Cash consideration	25,000
Add: Fair value of previously held equity interest in XYZ Ltd.	9,000
Total consideration	34,000
Less: Fair value of identifiable net assets acquired	(30,000)
Goodwill	4,000

2. The credit to retained earnings represents the reversal of the unrealized gain of ₹ 50 crore in Other Comprehensive Income related to the revaluation of property, plant and equipment. In accordance with Ind AS 16, this amount is not reclassified to profit or loss.

3. The gain on the previously held equity interest in XYZ Ltd. is calculated as follows:

₹ in crore

Fair Value of 30% interest in XYZ Ltd. at 1st April, 20X2	9,000
Carrying amount of interest in XYZ Ltd. at 1st April, 20X2	(8,850)
	150
Unrealised gain previously recognised in OCI	100
Gain on previously held interest in XYZ Ltd. recognised in profit or loss	250

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11.2 A Business Combination achieved without the Transfer of Consideration

An acquirer sometimes obtains control of an acquiree without transferring consideration. The acquisition method of accounting for a business combination applies to those combinations. Such circumstances include:

(a) The acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control.

(b) Minority veto rights lapse that previously kept the acquirer from controlling an acquiree in which the acquirer held the majority voting rights.

(c) The acquirer and acquiree agree to combine their businesses by contract alone. The acquirer transfers no consideration in exchange for control of an acquiree and holds no equity interests in the acquiree, either on the acquisition date or previously. Examples of business combinations achieved by contract alone include bringing two businesses together in a stapling arrangement or forming a dual listed corporation.

In a business combination achieved by contract alone, the acquirer shall attribute to the owners of the acquiree the amount of the acquiree's net assets recognised in accordance with this Indian Accounting Standard. In other words, the equity interests in the acquiree held by parties other than the acquirer are a non-controlling interest in the acquirer's post-combination financial statements even if the result is that all of the equity interests in the acquiree are attributed to the non-controlling interest.

11.3 Direct Cost of Acquisition

The direct cost of acquisition is not included in determination of the purchase consideration. Cost which include like finder's fees, due diligence cost accounting, legal fees, investment banker fees, even bonuses paid to employees for doing a successful acquisition will not be included in the cost of acquisition.

Illustration 11

Should stamp duty paid on acquisition of land pursuant to a business combination be capitalised to the cost of the asset or should it be treated as an acquisition related cost and accordingly be expensed off?

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Solution

As per Ind AS 103, the acquisition-related costs incurred by an acquirer to effect a business combination are not part of the consideration transferred.

Paragraph 53 of Ind AS 103 states that, acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception.

Note: The costs to issue debt or equity securities shall be recognised in accordance with Ind AS 32 and Ind AS 109.

The stamp duty payable for transfer of assets in connection with the business combination is an acquisition-related cost as described under paragraph 53 of Ind AS 103. Stamp duty is a cost incurred by the acquirer in order to effect the business combination and it is not part of the fair value exchange between the buyer and seller for the business. In such cases, the stamp duty is incurred to acquire the ownership rights in land in order to complete the process of transfer of assets as part of the overall business combination transaction but it does not represent consideration paid to gain control over business from the sellers.

It may be noted that the accounting treatment of stamp duty incurred for separate acquisition of an item of property, plant and equipment (i.e. not as part of business combination) differs under Ind AS 16, Property, Plant and Equipment. Unlike Ind AS 16, the acquisition accounting as per Ind AS 103 requires assets and liabilities acquired in a business combination to be measured at fair value. While incurred in connection with a business combination, stamp duty does not increase the future economic benefits from the net assets comprising the business (which would be recognised at fair value) and hence cannot be capitalised. The examples of costs given in paragraph 53 is only an inclusive list; they are only indicative and do not preclude any other cost to be considered as acquisition-related cost. In the given case, the transfer of land and the related stamp duty is required to be accounted as part of the business combination transaction as per requirements of Ind AS 103 and not as a separate transaction under Ind AS.

Accordingly, stamp duty incurred in relation to land acquired as part of a business combination transaction are required to be recognised as an expense in the period in which the acquisition is completed and given effect to in the financial statements of the acquirer.

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Illustration 12

ABC Ltd. acquires PQR Ltd. on 30th June, 20X1. The assets acquired from PQR Ltd. include an intangible asset that comprises wireless spectrum license. For this intangible asset, ABC Ltd. is required to make an additional one-time payment to the regulator in PQR's jurisdiction in order for the rights to be transferred for its use. Whether such additional payment to the regulator is an acquisition-related cost?

Solution

As per Ind AS 103, the acquisition-related costs incurred by an acquirer to effect a business combination are not part of the consideration transferred.

Paragraph 53 of Ind AS 103 states that, acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognised in accordance with Ind AS 32 and Ind AS 109.

The payment to the regulator represents a transaction cost and will be regarded as acquisition related cost incurred to effect the business combination. Applying the requirements of para 53 of Ind AS 103, it should be expensed as it is incurred. Transfer of rights in the instant case cannot be construed to be separate from the business combination because the transfer of the rights to ABC Ltd. is an integral part of the business combination itself.

It may be noted that had the right been acquired separately (i.e. not as part of business combination), the transaction cost is required to be capitalised as part of the intangible asset as per the requirements of Ind AS 38, Intangible Assets.

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11.4 Contingent Consideration

The consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement. The acquirer shall recognise the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree.

The acquirer shall classify an obligation to pay contingent consideration as a liability or as equity on the basis of the definitions of an equity instrument and a financial liability in accordance with the requirement of Ind AS 32 Financial Instruments: Presentation, or other applicable Indian Accounting Standards. The acquirer shall classify as an asset a right to the return of previously transferred consideration if specified conditions are met.

Fair value of the assets transferred or liability incurred should be measured on the acquisition date to determine the fair value. Any direct cost of acquisition should be recorded directly in profit and loss account and should not be included in purchase consideration.

Example :

Company A acquires Company B in April, 20X1 for cash. The acquisition agreement states that an additional ₹ 20 million of cash will be paid to B's former shareholders if B succeeds in achieving certain specified performance targets. A determines the fair value of the contingent consideration liability to be 15 million at the acquisition date. At a later date, the probability of meeting the said performance target becomes lower.

As certain consideration is based on achieving certain performance parameters in future, the consideration is contingent on achieving those parameters. As such, the transaction involves contingent consideration. Further, since the consideration is to be settled for a variable amount in cash, such consideration would be in the nature of financial liability rather than equity.

As at the acquisition date, the acquirer should consider the acquisition date fair value of contingent consideration as part of business combination. Accordingly, such recognition would increase goodwill (or reduce gain on bargain purchase, as the case may be).

In the above example, if the chance of meeting the performance criteria becomes less probable, then in such a case, the contingent consideration in the nature of financial liability should be remeasured and the impact for the change in the fair value should be recognised in statement of profit and loss.

12. PURCHASE PRICE ALLOCATION

12.1 Recognition of Assets and Liabilities of the Acquired Entity

As of the acquisition date, the acquirer shall recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree.

The most important principle in a purchase price allocation exercise is to recognize and measure all the assets and liabilities acquired on the acquisition date.

12.1.1 Recognition

Following conditions have to be considered while recognising the assets and liabilities of the acquire:

- To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in the Framework for the Preparation and Presentation of Financial Statements in accordance with Indian Accounting Standards issued by the Institute of Chartered Accountants of India at the acquisition date. For example, costs the acquirer expects but is not obliged to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree's employees are not liabilities at the acquisition date. Therefore, the acquirer does not recognise those costs as part of applying the acquisition method. Instead, the acquirer recognises those costs in its post combination financial statements in accordance with other Ind AS.
- Acquirer should only record the assets and liabilities recorded as a part of the business combination which means only those assets and liabilities which have been assumed as a part of the business combination deal should only be recorded and not any other assets which are not related to the acquisition to which other applicable Ind AS should be applied.
- When the acquirer applies the recognition principle under business combination it may record certain assets and liabilities which the acquiree had not recorded earlier in their financial statements. For example, the acquirer recognises the acquired identifiable intangible assets, such as a brand name, a patent or a customer relationship, that the acquiree did not recognise as assets in its financial statements because it developed them internally and charged the related costs to expense.

There are certain exceptions to specific assets and liabilities which have been discussed below.

- The assets and liabilities has to be classified as per the requirement of applicable Ind AS which will depend on the contractual terms, economic conditions etc.
- In some situations, Ind AS provide for different accounting depending on how an entity classifies or designates a particular asset or liability. Examples of classifications or designations that the acquirer shall make on the basis of the pertinent conditions as they exist at the acquisition date include but are not limited to:

- classification of particular financial assets and liabilities as measured at fair value through profit or loss or at amortised cost, or as a financial asset measured at fair value through other comprehensive income in accordance with Ind AS 109, Financial Instruments;
- designation of a derivative instrument as a hedging instrument in accordance with Ind AS 109; and
- assessment of whether an embedded derivative should be separated from a host contract in accordance with Ind AS 109 (which is a matter of 'classification' as this Ind AS uses that term).

The only exception to the above principle is that for lease contract (in which acquiree is the lessor as either an operating lease or a finance lease) and insurance contracts classification will be based on the basis of the conditions existing at inception and not on acquisition date.

12.2 Measurement Principle

The assets and liabilities recognized based on the aforesaid recognition principles has to be measured based on the following principles:

- The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values.
- For each business combination, the acquirer shall measure at the acquisition date components of non-controlling interest (under existing AS it is called as minority interest) in the acquiree that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation at either:
  - Fair value; or
  - The present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets
- All other components of non-controlling interests shall be measured at their acquisition date fair values, unless another measurement basis is required by Ind AS.

12.2.1 Exception to the recognition or measurement principle

The exception principles laid out in this standard for recognition or measurement of certain assets and liabilities are only limited to acquisition date accounting and may be different than the requirements of other accounting standards. The application of the above principles may result in two scenarios:

- An asset or liability which otherwise would not have been recorded gets recorded.
- The assets and liabilities are measured at a value other than the acquisition date fair values.

Items	Guidance under Ind AS 103
Contingent liability	Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets, defines a contingent liability as:

<table>
<tr><td></td><td>(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

(b) a present obligation that arises from past events but is not recognised because:

i. it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

ii. the amount of the obligation cannot be measured with sufficient reliability.

The requirements in Ind AS 37 do not apply in determining which contingent liabilities to recognise as of the acquisition date. Instead, the acquirer shall recognise as of the acquisition date a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably. Therefore, contrary to Ind AS 37, the acquirer recognises a contingent liability assumed in a business combination at the acquisition date even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.</td></tr>
<tr><td colspan="2">Example

A suit for damages worth ₹ 10 million was filed on Company B for alleged breach of certain contract provisions. Company B had disclosed the same as a contingent liability in its financial statements, as it considered that it is a present obligation for which it was not probable that the amount would be payable. Company A acquire Company B and determines the fair value of the contingent liability to be ₹ 2 million.

Company A would recognise ₹ 2 million in its financial statements as part of acquisition accounting, even if it is not probable that payment will be required to settle the obligation.</td></tr>
<tr><td>Income taxes</td><td>As per the requirement of Ind AS 12, no deferred tax consequence should be recorded on initial recognition of deferred tax except assets and liabilities acquired during business combination. Accordingly, the acquirer shall recognise and measure a deferred tax asset or liability arising from the assets acquired and liabilities assumed in a business combination in accordance with Ind AS 12, Income Taxes.</td></tr>
</table>

	The acquirer shall account for the potential tax effects of temporary differences and carry forwards of an acquiree that exist at the acquisition date or arise as a result of the acquisition in accordance with Ind AS 12.
Employee benefits	The acquirer records the fair value of the obligations for any post retirement obligation as per the principles of Ind AS 19 which is an exception of the general fair value rule.
Indemnification assets	The seller in a business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability. For example, the seller may indemnify the acquirer against losses above a specified amount on a liability arising from a particular contingency; in other words, the seller will guarantee that the acquirer's liability will not exceed a specified amount. As a result, the acquirer obtains an indemnification asset. The acquirer shall recognise an indemnification asset at the same time that it recognises the indemnified item measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts.

Example :

Company A acquires Company B in a business combination on 1st April, 20X1. B is being sued by one of its customers for breach of contract for ₹ 250. The sellers of B provide an indemnification to A for the reimbursement of any losses greater than ₹ 100. There are no collectability issues around this indemnification. At the acquisition date, Company A determined that there is a present obligation and therefore the fair value of the contingent liability of ₹ 250 is recognised by A in the acquisition accounting. In the acquisition accounting A also recognises an indemnification asset of ₹ 150 (₹ 250 - ₹ 100).

Illustration 13

ABC Ltd. acquired a beverage company PQR Ltd. from XYZ Ltd. At the time of the acquisition, PQR Ltd. is the defendant in a court case whereby certain customers of PQR Ltd. have alleged that its products contain pesticides in excess of the permissible levels that have caused them health damage.

PQR Ltd. is being sued for damages of ₹ 2 crore. XYZ Ltd. has indemnified ABC Ltd. for the losses, if any, due to the case for amount up to ₹ 1 crore. The fair value of the contingent liability for the court case is ₹ 70 lakh.

How should ABC Ltd. account for the contingent liability and the indemnification asset? What if the fair value of the liability is ₹ 1.2 crore instead of ₹ 70 lakh.

Solution

In the current scenario, ABC Ltd. measures the identifiable liability of entity PQR Ltd. at ₹ 70 lakh and also recognises a corresponding indemnification asset of ₹ 70 lakhs on its consolidated balance sheet. The net impact on goodwill from the recognition of the contingent liability and associated indemnification asset is nil.

However, in the case where the liability's fair value is more than ₹ 1 crore ie. ₹ 1.2 crore, the indemnification asset will be limited to ₹ 1 crore only.

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Illustration 14

ABC Ltd. pays ₹ 50 crore to acquire PQR Ltd. from XYZ Ltd. PQR Ltd. manufactured products containing fiber glass and has been named in 10 class actions concerning the effects of these fiber glass. XYZ Ltd. agrees to indemnify ABC Ltd. for the adverse results of any court cases up to an amount of ₹ 10 crore. The class actions have not specified amounts of damages and past experience suggests that claims may be up to ₹ 1 crore each, but that they are often settled for small amounts.

ABC Ltd. makes an assessment of the court cases and decides that due to the potential variance in outcomes, the contingent liability cannot be measured reliably and accordingly no amount is recognised in respect of the court cases. How should indemnification asset be accounted for?

Solution

Since no liability is recognised in the given case, ABC Ltd. will also not recognise an indemnification asset as part of the business combination accounting.

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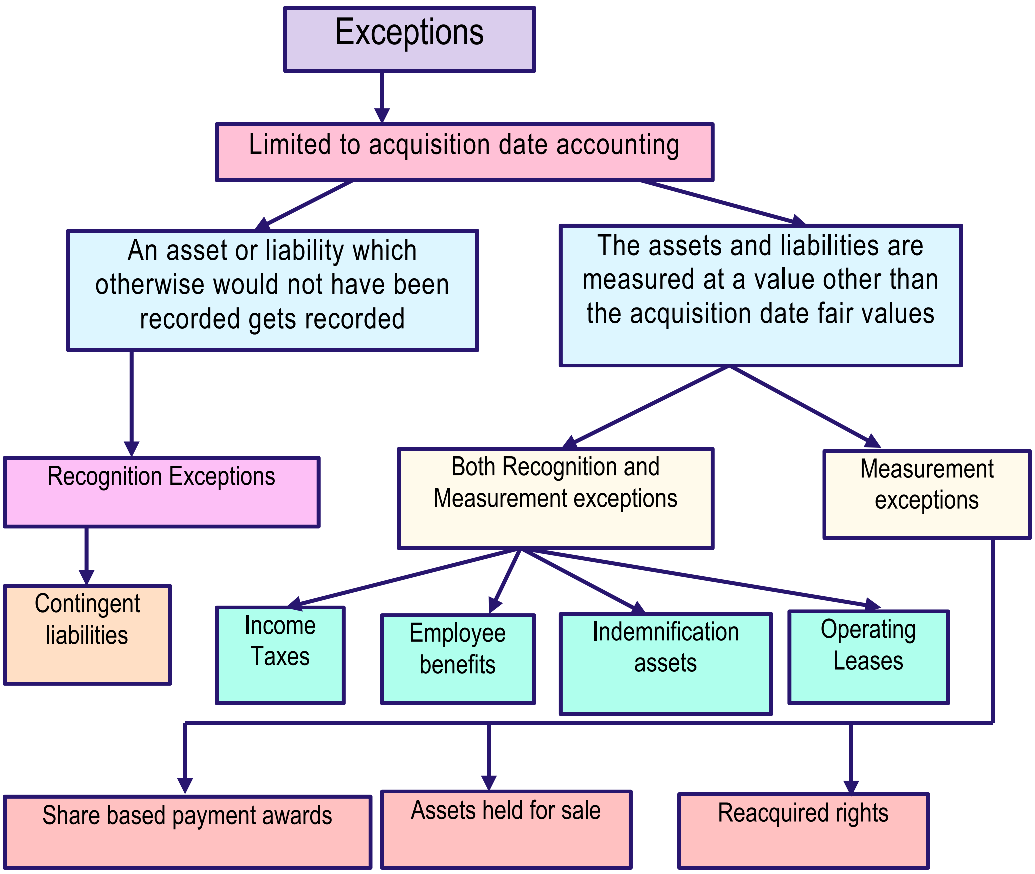
Reacquired rights	These are the rights which the acquirer before acquisition may have granted to the acquiree to use certain assets which belongs to the acquirer. It does not matter whether the asset was recorded in the financial statement of the acquirer or not. For example, license to use the brand name, Franchisee rights etc. if an acquirer acquires an acquiree which had certain rights granted to it by the acquirer then the business combination results in settlement of the right and accordingly any settlement gain or loss should be considered as a separate transaction from business combination and will be recorded in the financial statement of the acquirer. The acquirer shall measure the value of a reacquired right recognised as an intangible asset on the basis of the remaining contractual term of the related contract without considering the effect of potential renewals.

Intangible assets	The acquirer shall record separately from Goodwill, the identifiable intangible acquired in a business combination. An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion. (Refer a section below on intangible asset highlighting detailed guidance on recognition and measurement criteria)
Share based payment transactions	The acquirer shall measure a liability or an equity instrument related to share-based payment transactions of the acquiree or the replacement of an acquiree's share-based payment transactions with share-based payment transactions of the acquirer in accordance with the method in Ind AS 102, Share-based Payment, at the acquisition date.
Assets held for sale	The acquirer shall measure an acquired non-current asset (or disposal group) that is classified as held for sale at the acquisition date in accordance with Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations, at fair value less costs to sell in accordance with that Ind AS.
Leases	*Acquiree is a lessee* • ***The acquirer shall recognise right-of-use assets and lease liabilities for leases identified in accordance with Ind AS 116.*** • ***The acquirer is not required to recognise right-of-use assets and lease liabilities for:*** ***(a) leases for which the lease term ends within 12 months of the acquisition date; or*** ***(b) leases for which the underlying asset is of low value.*** • ***The acquirer shall measure the lease liability at the present value of the remaining lease payments as if the acquired lease were a new lease at the acquisition date.*** • ***The acquirer shall measure the right-of-use asset at the same amount as the lease liability, adjusted to reflect favourable or unfavourable terms of the lease when compared with market terms.*** *Acquiree is a lessor* ***In measuring the acquisition-date fair value of an asset, the acquirer shall take into account the terms of the lease. The acquirer does not recognise a separate asset or liability if the terms of an operating lease are either favourable or unfavourable when compared with market terms.***
Assembled workforce	The acquirer subsumes into Goodwill the value of an acquired intangible asset that is not identifiable as of the acquisition date. For

	example, an acquirer may attribute value to the existence of an assembled workforce, which is an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date. An assembled workforce does not represent the intellectual capital of the skilled workforce—the (often specialised) knowledge and experience that employees of an acquiree bring to their jobs. Because the assembled workforce is not an identifiable asset to be recognised separately from goodwill, any value attributed to it is subsumed into goodwill.
Unearned revenue	Unearned revenue arises because of the application of the revenue recognition criteria applied by the acquiree. It should be evaluated whether there is any obligation on the acquisition date to be fulfilled and accordingly an asset or liability against it should be recorded.



12.3 Intangible Assets

As explained above an intangible asset should be recorded separately from Goodwill if either the separability criteria is met or it arises out of contractual legal criterion.

12.3.1 Contractual Legal criterion

An intangible asset that meets the contractual-legal criterion is identifiable even if the asset is not transferable or separable from the acquiree or from other rights and obligations.

For example:

a. an acquiree owns and operates a nuclear power plant. The licence to operate that power plant is an intangible asset that meets the contractual-legal criterion for recognition separately from goodwill, even if the acquirer cannot sell or transfer it separately from the acquired power plant. An acquirer may recognise the fair value of the operating licence and the fair value of the power plant as a single asset for financial reporting purposes if the useful lives of those assets are similar.

b. an acquiree owns a technology patent. It has licensed that patent to others for their exclusive use outside the domestic market, receiving a specified percentage of future revenue in foreign exchange. Both the technology patent and the related licence agreement meet the contractual-legal criterion for recognition separately from goodwill even if selling or exchanging the patent and the related licence agreement separately from one another would not be practical.

12.3.2 Separability criteria

The separability criterion means that an acquired intangible asset is **capable** of being separated or divided from the acquiree and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability. An intangible asset that the acquirer would be able to sell, license or otherwise exchange for something else of value meets the separability criterion even if the acquirer does not intend to sell, license or otherwise exchange it. An acquired intangible asset meets the separability criterion if there is evidence of exchange transactions for that type of asset or an asset of a similar type, even if those transactions are infrequent and regardless of whether the acquirer is involved in them.

Example :

Customer and subscriber lists are frequently licensed and thus meet the separability criterion. Even if an acquiree believes its customer lists have characteristics different from other customer lists, the fact that customer lists are frequently licensed generally means that the acquired customer list meets the separability criterion. However, a customer list acquired in a business combination would not meet the separability criterion if the terms of confidentiality or other agreements prohibit an entity from selling, leasing or otherwise exchanging information about its customers.

An intangible asset that is not individually separable from the acquiree or combined entity meets the separability criterion if it is separable in combination with a related contract, identifiable asset or liability.

For example:

a. market participants exchange deposit liabilities and related depositor relationship intangible assets in observable exchange transactions. Therefore, the acquirer should recognise the depositor relationship intangible asset separately from goodwill.

b. an acquiree owns a registered trademark and documented but unpatented technical expertise used to manufacture the trademarked product. To transfer ownership of a trademark, the owner is also required to transfer everything else necessary for the new owner to produce a product or service indistinguishable from that produced by the former owner. Because the unpatented technical expertise must be separated from the acquiree or combined entity and sold if the related trademark is sold, it meets the separability criterion.

Accordingly, as per the guidance above it follows that identification of intangible asset will be judgemental and will vary in each case.

Following are the possible sources of information and broad indicator to be used to identify any possible intangible separately from goodwill:

A. Internal sources:

- **Financial statements of the acquiree-**
  - significant R&D cost may be indicator that there may be possible technology related intangible.
  - Significant sales promotion or marketing cost- this is a strong indicator of marketing related intangible like distributor network, Marketing collaterals etc.
  - Customer acquisition cost- lot of company spend money to acquire new customers like online e-commerce companies provide incentive to register a customer as a first time user or download their app. That may be a strong indicator of existence of customer list as an intangible.
- **Share purchase agreement-** This can also be a strong indicator of existence of any technical know-how, trademarks or patent which are included in the agreement can provide a indicator of an existence of an intangible.
- **Purpose of acquisition-** The reason for acquisition may also indicate the possible intangible to be recorded. For e.g. Coca Cola acquired Thumps Up with an intention to close the brand which will result in increase in its market share. Accordingly, this will also be a possible intangible asset.

Illustration 15

Company A, FMCG company acquires an online e-commerce company E, with the intention to start doing retailing. The e-commerce company has over the period have 10 million registered users. However, the e-commerce company E does not have any intention to sale the customer list. Should this customer list be recorded as an intangible in a business combination?

Solution

In this situation the customer database does not give rise to legal or contractual right. Accordingly, the assessment of its separability will be assessed. The database can be useful to other players and E has the ability to transfer this to them. Accordingly, the intention not to transfer will not affect the assessment whether to record this as an intangible or not.

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Illustration 16

ABC Ltd. a pharmaceutical group acquires XYZ Ltd. another pharmaceutical business. XYZ Ltd. has incurred significant research costs in connection with two new drugs that have been undergoing clinical trials. Out of the two drugs, one drug has not been granted necessary regulatory approvals. However, ABC Ltd. expects that approval will be given within two years. The other drug has recently received regulatory approval. The drugs' revenue-earning potential was one of the principal reasons why entity ABC Ltd. decided to acquire entity XYZ Ltd. Whether the research and development on either of the drugs be recognised as an intangible asset in the books of ABC Ltd.?

Solution

Ind AS 38, Intangible Assets provides explicit guidance on recognition of acquired in-process research and development.

Paragraph 21 of Ind AS 38 provides guidance regarding general recognition conditions which require it to be probable that expected future economic benefits will flow to the entity before an intangible asset can be recognised and for the cost to be measured reliably.

As per paragraph 33 of Ind AS 38, both of the standard's general recognition criteria, i.e. probability of benefits and reliable measurement, are always considered to be satisfied for intangible assets acquired in a business combination.

The fair value of an intangible asset reflects expectations about the probability of these benefits, despite uncertainty about the timing or the amount of the inflow. There will be sufficient information to measure the fair value of the asset reliably if it is separable or arises from contractual or other legal rights. If there is a range of possible outcomes with different probabilities, this uncertainty is taken into account in the measurement of the asset's fair value.

Paragraph 34 of Ind AS 38, provides that in accordance with this Standard and Ind AS 103, an acquirer recognises at the acquisition date, separately from goodwill, an intangible asset of the acquiree, irrespective of whether the asset had been recognised by the acquiree before the business combination.

This means that the acquirer recognises as an asset separately from goodwill an in-process research and development project of the acquiree if the project meets the definition of an intangible asset. An acquiree's in-process research and development project meets the definition of an intangible asset when it:

(a) meets the definition of an asset; and

(b) is identifiable, i.e. is separable or arises from contractual or other legal rights.

In accordance with above,

(i) The fair value of the first drug reflects the probability and the timing of the regulatory approval being obtained. As per the standard, the recognition criterion of probable future economic benefits is considered to be satisfied in respect of the asset acquired accordingly an asset is recognised. S ubsequent expenditure on an in-process research or development project acquired separately is to be dealt with in accordance with paragraph 43 of Ind AS 38.

(ii) The rights to the second drug also meet the recognition criteria in Ind AS 8 and are recognised. The approval means it is probable that future economic benefits will flow to ABC Ltd. This will be reflected in the fair value assigned to the intangible asset.

Thus, recognising in-process research and development as an asset on acquisition applies different criteria to those that are required for internal projects. The research costs of internal R&D projects may under no circumstances be capitalised as an intangible asset. It may be pertinent to note that entities will be required to recognise on acquisition some research and development expenditure that they would not have been able to recognise if it had been an internal project. Although the amount attributed to the project is accounted for as an asset, Ind AS 38 requires that any subsequent expenditure incurred after the acquisition of the project is to be accounted for in accordance with paragraphs 54 to 62 of Ind AS 38.

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12.3.3 Assembled workforce and other items that are not identifiable

The acquirer subsumes into goodwill the value of an acquired intangible asset that is not identifiable as of the acquisition date. For example, an acquirer may attribute value to the existence of an assembled workforce, which is an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date.

An assembled workforce does not represent the intellectual capital of the skilled workforce—the (often specialised) knowledge and experience that employees of an acquiree bring to their jobs. Because the assembled workforce is not an identifiable asset to be recognised separately from goodwill, any value attributed to it is subsumed into goodwill.

The acquirer also subsumes into goodwill any value attributed to items that do not qualify as assets at the acquisition date. For example, the acquirer might attribute value to potential contracts the acquiree is negotiating with prospective new customers at the acquisition date. Because those potential contracts are not themselves assets at the acquisition date, the acquirer does not recognise them separately from goodwill. The acquirer should not subsequently reclassify the value of those contracts from goodwill for events that occur after the acquisition date. However, the acquirer should assess the facts and circumstances surrounding events occurring shortly after the acquisition to determine whether a separately recognisable intangible asset existed at the acquisition date.

After initial recognition, an acquirer accounts for intangible assets acquired in a business combination in accordance with the provisions of Ind AS 38, Intangible Assets. However, as described in paragraph 3 of Ind AS 38, the accounting for some acquired intangible assets after initial recognition is prescribed by other Ind AS.

The identifiability criteria determine whether an intangible asset is recognised separately from goodwill. However, the criteria neither provides guidance for measuring the fair value of an intangible asset nor restrict the assumptions used in measuring the fair value of an intangible asset. For example, the acquirer would take into account the assumptions that market participants would use when pricing the intangible asset, such as expectations of future contract renewals, in measuring fair value. It is not necessary for the renewals themselves to meet the identifiability criteria.

12.4 Reacquired Rights

As part of a business combination, an acquirer may reacquire a right that it had previously granted to the acquiree to use one or more of the acquirer's recognised or unrecognised assets. Examples of such rights include a right to use the acquirer's trade name under a franchise agreement or a right to use the acquirer's technology under a technology licensing agreement. A reacquired right is an identifiable intangible asset that the acquirer recognises separately from goodwill.

If the terms of the contract giving rise to a reacquired right are favourable or unfavourable relative to the terms of current market transactions for the same or similar items, the acquirer shall recognise a settlement gain or loss.

Illustration 17

Vadapav Ltd. is a successful company has number of own stores across India and also offers franchisee to other companies. Efficient Ltd. is one of the franchisee of Vadapav Ltd. and is and operates number of store in south India. Vadapav Ltd. decided to acquire Efficient Ltd due to its huge distribution network and accordingly purchased the outstanding shares on 1st April, 20X2. On the acquisition date, Vadapav Ltd. determines that the license agreement reflects current market terms.

Solution

Vadapav will record the franchisee right as an intangible asset (reacquired right) while doing purchase price allocation and since it is at market terms no gain or loss will be recorded on settlement.

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Illustration 18

ABC Ltd. acquires PQR Ltd. for a consideration of ₹ 1 crore. Four years ago, ABC Ltd. had granted a ten-year license allowing PQR Ltd. to operate in Europe. The cost of the license was ₹ 2,50,000. The contract allows either party to terminate the franchise at a cost of the unexpired initial fee plus 20%. At the date of acquisition, the settlement amount is ₹ 1,80,000 [(₹ 2,50,000 x 6/10) + 20%].

ABC Ltd. has acquired PQR Ltd., because it sees high potential in the European market and wishes to exploit it. ABC Ltd. calculates that under current economic conditions and at current prices it could grant a six-year franchise for a price of ₹ 4,50,000.

How is the license accounted for as part of the business combination?

Solution

Paragraph B51 of Ind AS 103 provides that "the acquirer and acquiree may have a relationship that existed before they contemplated the business combination, referred to here as a 'pre-existing relationship'. A pre-existing relationship between the acquirer and acquiree may be contractual (for example, vendor and customer or licensor and licensee) or non-contractual (for example, plaintiff and defendant)."

Further, paragraph B52 of Ind AS 103 provides that "if the business combination in effect settles a pre-existing relationship, the acquirer recognises a gain or loss, measured as follows:

(a) for a pre-existing non-contractual relationship (such as a lawsuit), fair value.

(b) for a pre-existing contractual relationship, the lesser of (i) and (ii):

   (i) the amount by which the contract is favourable or unfavourable from the perspective of the acquirer when compared with terms for current market transactions for the same or similar items. (An unfavourable contract is a contract that is unfavourable in terms of current market terms. It is not necessarily an onerous contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.)

   (ii) the amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavourable.

   If (ii) is less than (i), the difference is included as part of the business combination accounting.

The amount of gain or loss recognised may depend in part on whether the acquirer had previously recognised a related asset or liability, and the reported gain or loss therefore may differ from the amount calculated by applying the above requirements."

Based on the above in the instant case, the license is recognised at ₹ 4,50,000, the fair value at market rates of a license based on the remaining contractual life.

The gain or loss on settlement of the contract is the lower of:

- ₹ 3,00,000, which is the amount by which the right is unfavorable to ABC Ltd. compared to market terms. This is the difference between the amount that ABC Ltd. could receive for granting a similar right, ₹ 4,50,000, compared to the carrying value (or the unamortised value) that it was granted for, ₹ 1,50,000 (2,50,000 X 6/10).
- ₹ 1,80,000, which is the amount that ABC Ltd. would have to pay to terminate the right at the date of acquisition.

The loss on settlement of the contract is ₹ 1,80,000. Therefore, out of the ₹ 1 crore paid, ₹ 98.2 lakh is accounted for as consideration for the business combination and ₹ 1,80,000 is accounted for separately as a settlement loss on the re-acquired right.

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12.5 Goodwill – Recognition and Measurement

The acquirer shall recognise Goodwill as of the acquisition date measured as the excess of (a) over (b) below:

a) the aggregate of:

   i. the purchase consideration transferred at acquisition-date fair value;

   ii. the amount of any non-controlling interest in the acquiree measured in accordance with this Ind AS (refer Non-controlling section); and

   iii. in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this Ind AS.

In a business combination in which the acquirer and the acquiree (or its former owners) exchange only equity interests, the acquisition-date fair value of the acquiree's equity interests may be more reliably measurable than the acquisition-date fair value of the acquirer's equity interests. If so, the acquirer shall determine the amount of goodwill by using the acquisition-date fair value of the acquiree's equity interests instead of the acquisition-date fair value of the equity interests transferred. To determine the amount of goodwill in a business combination in which no consideration is transferred, the acquirer shall use the acquisition-date fair value of the acquirer's interest in the acquiree in place of the acquisition-date fair value of the consideration transferred (paragraph 32(a)(i)).

12.6 Bargain Purchase

In extremely rare circumstances, an acquirer will make a bargain purchase in a business combination in which the net assets value acquired in a business combination exceeds the purchase consideration.

The acquirer shall recognise the resulting gain in other comprehensive income on the acquisition date and accumulate the same in equity as capital reserve, if the reason for bargain purchase gain is not clear. The gain shall be attributed to the acquirer and there will no allocation to the non-controlling shareholders.

A bargain purchase might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion.

The Ind AS itself acknowledges that it is very rare that a bargain purchase in a business combination will arise and accordingly the standard re-emphasise the above point by requiring the entities to reassess and identify the clear reason why it is a bargain purchase business combination. For e.g. acquisition of business in a bankruptcy sale, or sale of business due to a regulatory requirement.

Example :

Entity X is one of the largest liquor manufacturing company in the world and it acquires another Entity Y which has significant presence in India and UK. However, the competition commission in UK has issued orders to sell one division of the UK assets of Entity Y in order to comply with the local competition regulation in UK within a specified timeline. Entity Z another boutique liquor manufacturer realises the opportunity and purchase the assets of Entity Y from Entity X.

In the given case above it is more likely than not that there could be an element of bargain purchase as the Entity X was under compulsion to sell the assets within a specified timeline.

As mentioned above before recognising a gain on a bargain purchase, the acquirer shall determine whether there exists clear evidence of the underlying reasons for classifying the business combination as a bargain purchase. If such evidence exists, the acquirer shall reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and shall recognise any additional assets or liabilities that are identified in that review.

The acquirer shall then review the procedures used to measure the amounts this Ind AS requires to be recognised at the acquisition date for all of the following:

- the identifiable assets acquired and liabilities assumed;
- the non-controlling interest in the acquiree, if any;
- for a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree; and
- the consideration transferred.

The objective of the review is to ensure that the measurements appropriately reflect consideration of all available information as of the acquisition date.

Illustration 19

On 1st January, 20X1, A Ltd. acquires 80 per cent of the equity interests of B Ltd. in exchange for cash of ₹ 15 crore. The former owners of B Ltd. were required to dispose off their investments in B Ltd. by a specified date, and accordingly they did not have sufficient time to find potential buyers. A qualified valuation professional hired by the management of A Ltd. measures the identifiable net assets acquired, in accordance with the requirements of Ind AS 103, at ₹ 20 crore and the fair value of the 20 per cent non-controlling interest in B Ltd. at ₹ 4.2 crore. How should A Ltd. recognise the above bargain purchase?

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Solution

The amount of B Ltd.'s identifiable net assets i.e., ₹ 20 crore exceeds the fair value of the consideration transferred plus the fair value of the non-controlling interest in B Ltd. i.e. ₹ 19.2 crore. Therefore, A Ltd. should review the procedures it used to identify and measure the net assets acquired and the fair value of non-controlling interest in B Ltd. and the consideration transferred. After the review, A Ltd. decides that the procedures and resulting measures were appropriate. A Ltd. measures the gain on its purchase of the 80 per cent interest at ₹ 80 lakh, as the difference between the amount of the identifiable net assets which is ₹ 20 crore and the sum of purchase consideration and fair value of non-controlling interest, which is ₹ 19.2 crore (cash consideration of ₹ 15 crore and fair value of non-controlling interest of ₹ 4.2 crore).

Assuming there exists clear evidence of the underlying reasons for classifying the business combination as a bargain purchase, the gain on bargain purchase of 80 per cent interest calculated at ₹ 80 lakh, which will be recognised in other comprehensive income on the acquisition date and accumulated the same in equity as capital reserve.

If the acquirer chose to measure the non-controlling interest in B Ltd. on the basis of its proportionate share of identifiable net assets of the acquiree, the recognised amount of the non-controlling interest would be ₹ 4 crore (₹ 20 crore × 0.20). The gain on the bargain purchase then would be ₹ 1 crore (₹ 20 crore – (₹ 15 crore + ₹ 4 crore)).

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12.7 Measurement Period

Ind AS 103 provides a measurement period window wherein if all the required information is not available on the acquisition date then the entity will be required to do the purchase price allocation on a provision basis. During the measurement period, the acquirer shall retrospectively adjust the provisional amounts recognised at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognised as of that date.

During the measurement period, the acquirer shall also recognise additional assets or liabilities if new information is obtained about facts and circumstances that existed as of the acquisition date.

The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. However, the measurement period shall not exceed one year from the acquisition date.

The measurement period provides the acquirer with a reasonable time to obtain the information necessary to identify and measure the following as of the acquisition date in accordance with the requirements of this Ind AS:

- the identifiable assets acquired, liabilities assumed and any non-controlling interest in the acquiree;
- the consideration transferred for the acquiree (or the other amount used in measuring goodwill);
- in a business combination achieved in stages, the equity interest in the acquire previously held by the acquirer; and
- the resulting goodwill or gain on a bargain purchase.

Any change i.e. increase and decrease in the net assets acquired due to new information available during the measurement period which existed on the acquisition date will be adjusted against goodwill.

However, after the measurement period ends, any change in the value of assets and liabilities due to an information which existed on the valuation date will be accounted as an error as per Ind AS 8, Accounting policies, Changes in Accounting Estimates and Errors.

Illustration 20

Entity X acquired 100% shareholding of Entity Y on 1st April, 20X1 and had complete the preliminary purchase price allocation and accordingly recorded net assets of ₹ 100 million against the purchase consideration of 150 million. Entity Y had significant carry forward losses on which deferred tax asset was not recorded due to lack of convincing evidence on the acquisition date. However, on 31st March, 20X2, Entity Y won a significant contract which is expected to generate enough taxable income to recoup the losses. Accordingly, the deferred tax asset was recorded on the carry forward losses on 31st March, 20X2. Whether the aforesaid losses can be adjusted with the Goodwill recorded based on the preliminary purchase price allocation?

Solution

No, as per the requirement of Ind AS 103, changes to the net assets are allowed which results from the discovery of a fact which existed on the acquisition date. However, change of facts resulting in recognition and de-recognition of assets and liabilities after the acquisition date will be accounted in accordance with other Ind AS. In the above scenario deferred tax asset was not eligible for recognition on the acquisition date and accordingly the new contract on 31st March, 20X2 will tantamount to change of estimate and accordingly will not impact the Goodwill amount.

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Illustration 21

ABC Ltd. acquires XYZ Ltd. in a business combination on 15th January, 20X1. Few days before the date of acquisition, one of XYZ Ltd.'s customers had claimed that certain amounts were due by XYZ Ltd. under penalty clauses for completion delays included in the contract.

ABC Ltd. evaluates the dispute based on the information available at the date of acquisition and concludes that XYZ Ltd. was responsible for at least some of the delays in completing the contract. Based on the evaluation, ABC Ltd. recognises ₹ 1 crore towards this liability which is its best estimate of the fair value of the liability to the customer based on the information available at the date of acquisition.

In October, 20X1 (within the measurement period), the customer presents additional information as per which ABC Ltd. concludes the fair value of liability on the date of acquisition to be ₹ 2 crore.

ABC Ltd. continues to receive and evaluate information related to the claim after October, 20X1. Its evaluation doesn't change till February, 20X2 (i.e. after the measurement period), when it concludes that the fair value of the liability for the claim at the date of acquisition is ₹ 1.9 crore. ABC Ltd. determines that the amount that would be recognised with respect to the claim under Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets as at February, 20X2 is ₹ 2.2 crore.

How should the adjustment to the provisional amounts be made in the financial statements during and after the measurement period?

Solution

The consolidated financial statements of ABC Ltd. for the year ended 31st March, 20X1 should include ₹ 1 crore towards the contingent liability in relation to the customer claim.

When the customer presents additional information in support of its claim, the incremental liability of ₹ 1 crore (₹ 2 crore – ₹ 1 crore) will be adjusted as a part of acquisition accounting as it is within the measurement period. In its financial statements for the year ending on 31st March, 20X2, ABC Ltd. will disclose the amounts and explanations of the adjustments to the provisional values recognized during the current reporting period. Therefore, it will disclose that the comparative information for the year ending on 31st March, 20X1 is adjusted retrospectively to increase the fair value of the item of liability at the acquisition date by ₹ 1 crore, resulting in a corresponding increase in goodwill.

The information resulting in the decrease in the estimated fair value of the liability for the claim in February, 20X2 was obtained after the measurement period. Accordingly, the decrease is not recognised as an adjustment to the acquisition accounting. If the amount determined in accordance with Ind AS 37 subsequently exceeds the previous estimate of the fair value of the liability, then ABC Ltd. recognises an increase in the liability. As the change has occurred after the end of the measurement period, the increase in the liability amounting to ₹ 20 lakh (₹ 2.2 crore– ₹ 2 crore) is recognised in profit or loss.

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12.8 Determining what is part of the Business Combination Transaction

The acquirer and the acquiree may have a pre-existing relationship or other arrangement before negotiations for the business combination began, or they may enter into an arrangement during the negotiations that is separate from the business combination. In either situation, the acquirer shall identify any amounts that are not part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination, ie amounts that are not part of the exchange for the acquiree. The acquirer shall recognise as part of applying the acquisition method only the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree. Separate transactions shall be accounted for in accordance with the relevant Ind AS.

A transaction entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer or the combined entity, rather than primarily for the benefit of the acquire (or its former owners) before the combination, is likely to be a separate transaction. The following are examples of separate transactions that are not to be included in applying the acquisition method:

- a transaction that in effect settles pre-existing relationships between the acquirer and acquiree;
- a transaction that remunerates employees or former owners of the acquiree for future services; and
- a transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs.

The acquirer should consider the following factors, which are neither mutually exclusive nor individually conclusive, in determining whether the transaction is separate from Business combination:

I. **The reasons for the transaction-** Understanding the reasons why the parties to the combination (the acquirer and the acquiree and their owners, directors and managers -and their agents) entered into a particular transaction or arrangement may provide insight into whether it is part of the consideration transferred and the assets acquired or liabilities assumed. For example, if a transaction is arranged primarily for the benefit of the acquirer or the combined entity rather than primarily for the benefit of the acquiree or its former owners before the combination, that portion of the transaction price paid (and any related assets or liabilities) is less likely to be part of the exchange for the acquiree. Accordingly, the acquirer would account for that portion separately from the business combination.

II. **Who initiated the transaction—**Understanding who initiated the transaction may also provide insight into whether it is part of the exchange for the acquiree. For example, a transaction or other event that is initiated by the acquirer may be entered into for the purpose of providing future economic benefits to the acquirer or combined entity with little or no benefit received by the acquiree or its former owners before the combination. On the other hand, a transaction or arrangement initiated by the acquiree or its former owners is less likely to be for the benefit of the acquirer or the combined entity and more likely to be part of the business combination transaction.

III. **The timing of the transaction—**The timing of the transaction may also provide insight into whether it is part of the exchange for the acquiree. For example, a transaction between the acquirer and the acquiree that takes place during the negotiations of the terms of a business combination may have been entered into in contemplation of the business combination to provide future economic benefits to the acquirer or the combined entity. If so, the acquiree or its former owners before the business combination are likely to receive little or no benefit from the transaction except for benefits they receive as part of the combined entity.

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Illustration 22

Progressive Ltd is being sued by Regressive Ltd for an infringement of its Patent. At 31st March, 20X2, Progressive Ltd recognised a ₹ 10 million liability related to this litigation.

On 30th July, 20X2, Progressive Ltd acquired the entire equity of Regressive Ltd for ₹ 500 million. On that date, the estimated fair value of the expected settlement of the litigation is ₹ 20 million.

Solution

In the above scenario the litigation is in substance settled with the business combination transaction and accordingly the ₹ 20 million being the fair value of the litigation liability will be considered as paid for settling the litigation claim and will be not included in the business combination. Accordingly, the purchase price will reduce by 20 million and the difference between 20 and 10 will be recorded in income statement of the Progressive limited as loss on settlement of the litigation.

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12.9 Contingent Payments to Employee Shareholders

Whether arrangements for contingent payments to employees or selling shareholders are contingent consideration in the business combination or are separate transactions depends on the nature of the arrangements. Understanding the reasons why the acquisition agreement includes a provision for contingent payments, who initiated the arrangement and when the parties entered into the arrangement may be helpful in assessing the nature of the arrangement.

If it is not clear whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or is a transaction separate from the business combination, the acquirer should consider the following indicators:

a) **Continuing employment**—The terms of continuing employment by the selling shareholders who become key employees may be an indicator of the substance of a contingent consideration arrangement. The relevant terms of continuing employment may be included in an employment agreement, acquisition agreement or some other document. A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is remuneration for post-combination services. Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than remuneration.

b) **Duration of continuing employment**—If the period of required employment coincides with or is longer than the contingent payment period, that fact may indicate that the contingent payments are, in substance, remuneration.

c) **Level of remuneration**—Situations in which employee remuneration other than the contingent payments is at a reasonable level in comparison with that of other key employees in the combined entity may indicate that the contingent payments are additional consideration rather than remuneration.

d) **Incremental payments to employees**—If selling shareholders who do not become employees receive lower contingent payments on a per-share basis than the selling shareholders who become employees of the combined entity, that fact may indicate that the incremental amount of contingent payments to the selling shareholders who become employees is remuneration.

e) **Number of shares owned—**The relative number of shares owned by the selling shareholders who remain as key employees may be an indicator of the substance of the contingent consideration arrangement. For example, if the selling shareholders who owned substantially all of the shares in the acquiree continue as key employees, that fact may indicate that the arrangement is, in substance, a profit sharing arrangement intended to provide remuneration for post-combination services. Alternatively, if selling shareholders who continue as key employees owned only a small number of shares of the acquiree and all selling shareholders receive the same amount of contingent consideration on a per-share basis, that fact may indicate that the contingent payments are additional consideration. The pre-acquisition ownership interests held by parties related to selling shareholders who continue as key employees, such as family members, should also be considered.

f) **Linkage to the valuation—**If the initial consideration transferred at the acquisition date is based on the low end of a range established in the valuation of the acquire and the contingent formula relates to that valuation approach, that fact may suggest that the contingent payments are additional consideration. Alternatively, if the contingent payment formula is consistent with prior profit-sharing arrangements, that fact may suggest that the substance of the arrangement is to provide remuneration.

g) **Formula for determining consideration—**The formula used to determine the contingent payment may be helpful in assessing the substance of the arrangement. For example, if a contingent payment is determined on the basis of a multiple of earnings, that might suggest that the obligation is contingent consideration in the business combination and that the formula is intended to establish or verify the fair value of the acquiree. In contrast, a contingent payment that is a specified percentage of earnings might suggest that the obligation to employees is a profit sharing arrangement to remunerate employees for services rendered.

h) **Other agreements and issues—**The terms of other arrangements with selling shareholders (such as agreements not to compete, executory contracts, consulting contracts and property lease agreements) and the income tax treatment of contingent payments may indicate that contingent payments are attributable to something other than consideration for the acquiree. For example, in connection with the acquisition, the acquirer might enter into a property lease arrangement with a significant selling shareholder. If the lease payments specified in the lease contract are significantly below market, some or all of the contingent payments to the lessor (the selling shareholder) required by a separate arrangement for contingent payments might be, in substance, payments for the use of the leased property that the acquirer should recognise separately in its post-combination financial statements. In contrast, if the lease contract specifies lease payments that are consistent with market terms for the leased property, the arrangement for contingent payments to the selling shareholder may be contingent consideration in the business combination.

Illustration 23

KKV Ltd acquires a 100% interest in VIVA Ltd, a company owned by a single shareholder who is also the KMP in the Company, for a cash payment of USD 20 million and a contingent payment of USD 2 million. The terms of the agreement provide for payment 2 years after the acquisition if the following conditions are met:

- *the EBIDTA margins of the Company after 2 years after the acquisition is 21%.*
- *the former shareholder continues to be employed with VIVA Ltd for at least 2 years after the acquisition. No part of the contingent payment will be paid if the former shareholder does not complete the 2 year employment period.*

Solution

In the above scenario the former shareholder is required to continue in employment and the contingent consideration will be forfeited if the employment is terminated or if he resigns.

Accordingly, only USD 20 million is considered as purchase consideration and the contingent consideration is accounted as employee cost and will be accounted as per the other Ind AS.

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Illustration 24 : Contingent consideration- Payments to employees who are former owners of acquiree

ABC Ltd. acquires all of the outstanding shares of XYZ Ltd. in a business combination. XYZ Ltd. had three shareholders with equal shareholdings, two of whom were also senior-level employees of XYZ Ltd. and would continue as employee post acquisition of shares by ABC Ltd.

- The employee shareholders each will receive ₹ 60,00,000 plus an additional payment of ₹ 1,50,00,000 to 2,00,00,000 based on a multiple of earnings over the next two years.
- The non-employee shareholders each receive ₹ 1,00,00,000.

The additional payment of each of these employee shareholders will be forfeited if they leave the employment of XYZ Ltd. at any time during the two years following its acquisition by ABC Ltd. The salary received by them is considered reasonable remuneration for their services.

How much amount is attributable to post combination services?

Solution

Paragraph B55(a) of Ind AS 103 provides an indication that a contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is remuneration for post-combination services.

Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than remuneration.

In accordance with the above, in the instant case, the additional consideration of ₹ 1,50,00,000 to ₹ 2,00,00,000 represents compensation for post-combination services, as the same represents that part of the payment which is forfeited if the former shareholder does not remain in the employment of XYZ Ltd. for two years following the acquisition - i.e., only ₹ 60,00,000 is attributed to consideration in exchange for the acquired business.

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12.10 Acquirer Share Based Payment Awards Exchanged for Awards held by the Acquiree's Employees

- An acquirer may exchange its share-based payment awards (replacement awards) for awards held by employees of the acquiree.
- The above share based payment awards will include vested and unvested shares.
- Exchanges of share options or other share-based payment awards in conjunction with a business combination are accounted for as modifications of share-based payment awards in accordance with Ind AS 102, Share based Payment.

- If the acquirer replaces the acquiree awards, either all or a portion of the market-based measure of the acquirer's replacement awards shall be included in measuring the consideration transferred in the business combination. Market based measure means that awards will be re-measured on the acquisition date as per the requirements of Ind AS 102.
- In situations in which acquiree awards would expire as a consequence of a business combination and if the acquirer replaces those awards when it is not obliged to do so, all of the market-based measure of the replacement awards shall be recognised as remuneration cost in the post-combination financial statements in accordance with Ind AS 102. That is to say, none of the market-based measure of those awards shall be included in measuring the consideration transferred in the business combination. The acquirer is obliged to replace the acquiree awards if the acquiree or its employees have the ability to enforce replacement.

  For example, for the purposes of applying this guidance, the acquirer is obliged to replace the acquiree's awards if replacement is required by:

  (a) the terms of the acquisition agreement;

  (b) the terms of the acquiree's awards; or

  (c) applicable laws or regulations.
- To determine the portion of a replacement award that is part of the consideration transferred for the acquiree and the portion that is remuneration for post-combination service, the acquirer shall measure both the replacement awards granted by the acquirer and the acquiree awards as of the acquisition date in accordance with Ind AS 102. The portion of the market-based measure of the replacement award that is part of the consideration transferred in exchange for the acquiree equals the portion of the acquiree award that is attributable to pre-combination service.
- The portion of the replacement award attributable to pre-combination service is the market-based measure of the acquiree award multiplied by the ratio of the portion of the vesting period completed to the greater of the total vesting period or the original vesting period of the acquiree award. The vesting period is the period during which all the specified vesting conditions are to be satisfied. Vesting conditions are defined in Ind AS 102.
- The portion of a non-vested replacement award attributable to post-combination service, and therefore recognised as remuneration cost in the post-combination financial statements, equals the total market-based measure of the replacement award less the amount attributed to pre-combination service. Therefore, the acquirer attributes any excess of the market-based measure of the replacement award over the market-based measure of the acquiree award to post-combination service and recognises that excess as remuneration cost in the post-combination financial statements.
- The acquirer shall attribute a portion of a replacement award to post-combination service if it requires post combination service, regardless of whether employees had rendered all of the service required for their acquiree awards to vest before the acquisition date.

- The portion of a non-vested replacement award attributable to pre-combination service, as well as the portion attributable to post-combination service, shall reflect the best available estimate of the number of replacement awards expected to vest.

  For example, if the market-based measure of the portion of a replacement award attributed to pre-combination service is ₹ 100 and the acquirer expects that only 95 per cent of the award will vest, the amount included in consideration transferred in the business combination is ₹ 95.

- Changes in the estimated number of replacement awards expected to vest are reflected in remuneration cost for the periods in which the changes or forfeitures occur not as adjustments to the consideration transferred in the business combination. Similarly, the effects of other events, such as modifications or the ultimate outcome of awards with performance conditions, that occur after the acquisition date are accounted for in accordance with Ind AS 102 in determining remuneration cost for the period in which an event occurs.
- The same requirements for determining the portions of a replacement award attributable to pre-combination and post-combination service apply regardless of whether a replacement award is classified as a liability or as an equity instrument in accordance with the provisions of Ind AS 102. All changes in the market-based measure of awards classified as liabilities after the acquisition date and the related income tax effects are recognised in the acquirer's post-combination financial statements in the period(s) in which the changes occur.
- The income tax effects of replacement awards of share-based payments shall be recognised in accordance with the provisions of Ind AS 12, Income Taxes.

The above guidance on Share based payment as per the Ind AS 103 can be summarized as follows:

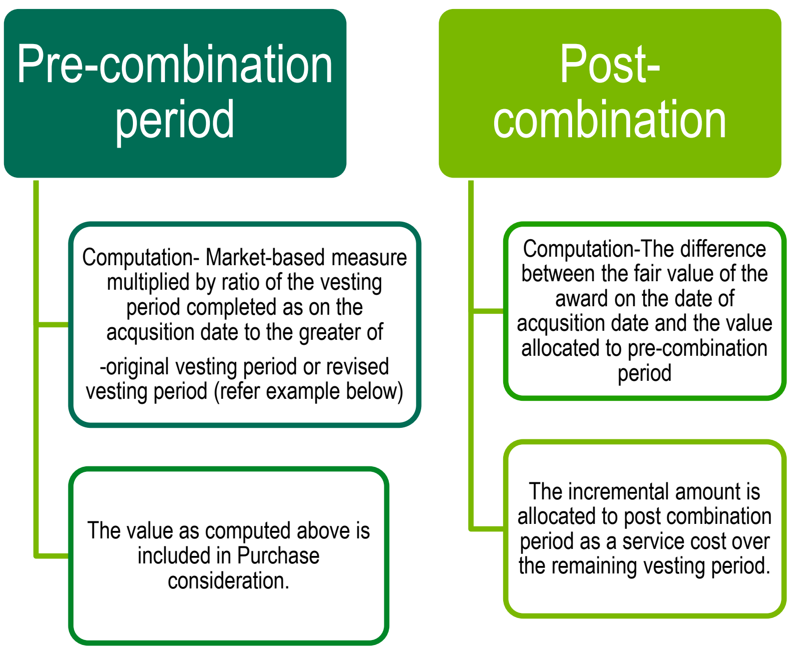


Illustration 25

Green Ltd acquired Pollution Ltd. as a part of the arrangement Green Ltd had to replace the Pollution Ltd.'s existing equity-settled award. The original awards specify a vesting period of five years. At the acquisition date, Pollution Ltd employees have already rendered two years of service.

As required, Green Ltd replaced the original awards with its own share-based payment awards (replacement award). Under the replacement awards, the vesting period is reduced to 2 year (from the acquisition date).

The value (market-based measure) of the awards at the acquisition date are as follows:

- *original awards: ₹ 500*
- *replacement awards: ₹ 600.*

As of the acquisition date, all awards are expected to vest.

Solution

Pre-combination period

The value of the replacement awards will have to be allocated between the pre-combination and post combination period. As of the acquisition date, the fair value of the original award (₹ 500) will be multiplied by the service rendered upto acquisition date (2 years) divided by greater of original vesting period (5 years) or new vesting period (4 years). Accordingly, 500 x 2/5= 200 will be considered as pre-combination service and will be included in the purchase consideration.

Post- Combination period

The fair value of the award on the acquisition date is 600 which means the difference between the replacement award which is 600 and the amount allocated to pre-combination period (200) is 400 which will be now recorded over the remaining vesting period which is 2 years as an employee compensation cost.

*****

12.11 Non-replacement Awards

The acquiree may have outstanding share-based payment transactions that the acquirer does not exchange for its share-based payment transactions. If vested, those acquiree share-based payment transactions are part of the non-controlling interest in the acquiree and are measured at their market-based measure. If unvested, they are measured at their market-based measure as if the acquisition date were the grant date in accordance with paragraphs 19 and 30.

The market-based measure of unvested share-based payment transactions is allocated to the non-controlling interest on the basis of the ratio of the portion of the vesting period completed to the greater of the total vesting period and the original vesting period of the share-based payment transaction. The balance is allocated to post-combination service.

The above means that the acquiree's existing award will be settled in its own shares and the consequential shareholders will become the Non-controlling shareholders. The above principles can be summarized as follows:

Vested shares-

- the value credited to Share based payment reserve is classified as NCI.

Unvested-

- Pre-combination period is considered as a part of NCI
- Post-combination period- is recorded as employee cost and the credit forms part of the NCI in the balance sheet.

Illustration 26

P a real estate company acquires Q another construction company which has an existing equity settled share based payment scheme. The awards vest after 5 years of employee service. At the acquisition date, Company Q's employees have rendered 2 years of service. None of the awards are vested at the acquisition date. P did not replace the existing share-based payment scheme but reduced the remaining vesting period from 3 years to 2 year. Company P determines that the market-based measure of the award at the acquisition date is ₹ 500 (based on measurement principles and conditions at the acquisition date as per Ind AS 102).

Solution

The market based measure or the fair value of the award on the acquisition date of 500 is allocated NCI and post combination employee compensation expense. The portion allocable to pre-combination period is 500 x 2/5 = 200 which will be included in pre-combination period and is allocated to NCI on the acquisition date. The amount is computed based on original vesting period.

The remaining expense which is 500-200= 300 is accounted over the remaining vesting period of 2 years as compensation expenses.

*****

12.12 Non-controlling Interest in an Acquiree

Ind AS 103 allows the acquirer to measure a non-controlling interest in the acquiree at its fair value at the acquisition date. Sometimes an acquirer will be able to measure the acquisition-date fair value of a non-controlling interest on the basis of a quoted price in an active market for the equity shares (ie those not held by the acquirer). In other situations, however, a quoted price in an active market for the equity shares will not be available. In those situations, the acquirer would measure the fair value of the non-controlling interest using other valuation techniques.

The fair values of the acquirer's interest in the acquiree and the non-controlling interest on a per-share basis might differ. The main difference is likely to be the inclusion of a control premium in the per-share fair value of the acquirer's interest in the acquiree or, conversely, the inclusion of a discount for lack of control (also referred to as a non-controlling interest discount) in the per-share fair value of the non-controlling interest if market participants would take into account such a premium or discount when pricing the non-controlling interest.

Illustration 27

Classic Ltd. acquires 60% of the ordinary shares of Natural Ltd. a private entity, for ₹ 97.5 crore. The fair value of its identifiable net assets is ₹ 150 crore. The fair value of the 40% of the ordinary shares owned by non-controlling shareholders is ₹ 65 crore. Carrying amount of Natural Ltd.'s net assets is ₹ 120 crore.

How will the non-controlling interest be measured?

Solution

Paragraph 19 of Ind AS 103 states that for each business combination, the acquirer shall measure at the acquisition date components of non-controlling interest in the acquiree that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation at either:

(a) fair value; or

(b) the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets.

All other components of non-controlling interests shall be measured at their acquisition-date fair values, unless another measurement basis is required by Ind AS.

In accordance with above, non-controlling interests will be measured in either of the following manner:

(a) Non-controlling interests are measured at fair value

Under this method, goodwill represents the difference between the fair value of Natural Ltd. and the fair value of its identifiable net assets.

Thus, Classic Ltd. will recognise the business combination as follows:

(₹ in crores)

Identifiable net assets at fair value	Dr	150	
Goodwill*	Dr	12.5	
To Non-controlling interest			65
To Investment in Natural Ltd.			97.5

*Note: Goodwill is calculated as 97.5+65-150 = 12.5 or 162.5-150 = 12.5

(b) Non-controlling interests are measured at proportionate share of identifiable net assets

Under this method, goodwill represents the difference between the total of the consideration transferred less the fair value of the acquirer's share of net assets acquired and liabilities assumed. The non-controlling interests that are present ownership interests and entitle their holders to a proportionate share of the Natural Ltd 's net assets in the event of liquidation (i.e. the ordinary shares) are measured at the non-controlling interest's proportionate share of the identifiable net assets of Natural Ltd.

Thus, Classic will recognise the business combination as follows:

(₹ in Crores)

Identifiable net assets at fair value	Dr	150	
Goodwill*	Dr	7.5	
To Non-controlling interest (40% x 150) Cr			60
To Investment in Natural Ltd. Cr			97.5

*Note: Goodwill is calculated as 97.5+60-150 = 7.5 or 97.5-(150 x 60%) = 7.5

*****

13. SUBSEQUENT MEASUREMENT AND ACCOUNTING

In general, an acquirer shall subsequently measure and account for assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination in accordance with other applicable Ind AS for those items, depending on their nature. However, this Ind AS provides guidance on subsequently measuring and accounting for the following assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination:

a) reacquired rights;

b) contingent liabilities recognised as of the acquisition date;

c) indemnification assets; and

d) Contingent consideration.

13.1 Reacquired Rights

A reacquired right recognised as an intangible asset shall be amortised over the remaining contractual period of the contract in which the right was granted. An acquirer that subsequently sells a reacquired right to a third party shall include the carrying amount of the intangible asset in determining the gain or loss on the sale.

13.2 Contingent Liabilities

After initial recognition and until the liability is settled, cancelled or expires, the acquirer shall measure a contingent liability recognised in a business combination at the higher of:

(a) the amount that would be recognised in accordance with Ind AS 37; and

(b) the amount initially recognised less, if appropriate, the cumulative amount of income recognised in accordance with the principles of Ind AS 115, Revenue from Contracts with Customers.

13.3 Indemnification Assets

At the end of each subsequent reporting period, the acquirer shall measure an indemnification asset that was recognised at the acquisition date on the same basis as the indemnified liability or asset, subject to any contractual limitations on its amount and, for an indemnification asset that is not subsequently measured at its fair value, management's assessment of the collectability of the indemnification asset. The acquirer shall derecognise the indemnification asset only when it collects the asset, sells it or otherwise loses the right to it.

13.4 Contingent Consideration

Some changes in the fair value of contingent consideration that the acquirer recognises after the acquisition date may be the result of additional information that the acquirer obtained after that date about facts and circumstances that existed at the acquisition date.

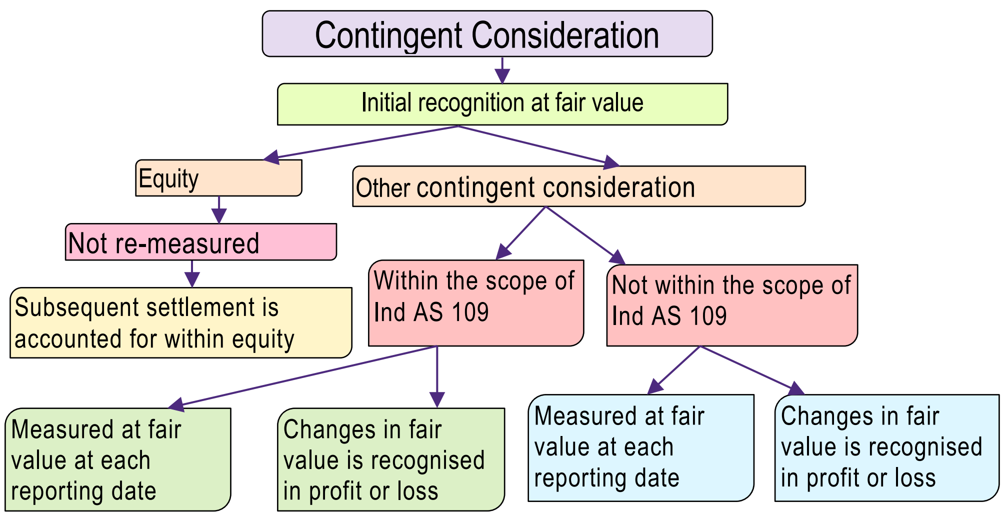
Such changes are measurement period adjustments to the extent it is on account of conditions which existed as of the acquisition date will be adjusted against goodwill. However, changes resulting from events after the acquisition date, such as meeting an earnings target, reaching a specified share price or reaching a milestone on a research and development project, are not measurement period adjustments. The acquirer shall account for changes in the fair value of contingent consideration that are not measurement period adjustments as follows:

(a) Contingent consideration classified as equity shall not be re-measured and its subsequent settlement shall be accounted for within equity.

(b) Other contingent consideration that:

i. is within the scope of Ind AS 109 shall be measured at fair value at each reporting date and changes in fair value shall be recognised in profit or loss in accordance with Ind AS 109.

ii. is not within the scope of Ind AS 109 shall be measured at fair value at each reporting date and changes in fair value shall be recognised in profit or loss.



14. DISCLOSURES

The acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs either:

a) during the current reporting period; or

b) after the end of the reporting period but before the financial statements are approved for issue.

Ind AS 103 requires detailed disclosures on Business Combination. The acquirer shall disclose the following information for each business combination that occurs during the reporting period:

a. the name and a description of the acquiree.

b. the acquisition date.

c. the percentage of voting equity interests acquired.

d. the primary reasons for the business combination and a description of how the acquirer obtained control of the acquiree.

e. a qualitative description of the factors that make up the goodwill recognised, such as expected synergies from combining operations of the acquiree and the acquirer, intangible assets that do not qualify for separate recognition or other factors.

f. the acquisition-date fair value of the total consideration transferred and the acquisition-date fair value of each major class of consideration, such as:

    I. cash;

    II. other tangible or intangible assets, including a business or subsidiary of the acquirer;

    III. liabilities incurred, for example, a liability for contingent consideration; and

    IV. equity interests of the acquirer, including the number of instruments or interests issued or issuable and the method of measuring the fair value of those instruments or interests.

g. for contingent consideration arrangements and indemnification assets:

    i. the amount recognised as of the acquisition date;

    ii. a description of the arrangement and the basis for determining the amount of the payment; and

    iii. an estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer shall disclose that fact.

h. for acquired receivables:

    i. the fair value of the receivables;

    ii. the gross contractual amounts receivable; and

   iii. the best estimate at the acquisition date of the contractual cash flows not expected to be collected. The disclosures shall be provided by major class of receivable, such as loans, direct finance leases and any other class of receivables.

i. the amounts recognised as of the acquisition date for each major class of assets acquired and liabilities assumed.

j. for each contingent liability recognised, the information required in paragraph 85 of Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets. If a contingent liability is not recognised because its fair value cannot be measured reliably, the acquirer shall disclose:

   i. the information required by paragraph 86 of Ind AS 37; and

   ii. the reasons why the liability cannot be measured reliably.

k. the total amount of goodwill that is expected to be deductible for tax purposes.

l. for transactions that are recognised separately from the acquisition of assets and assumption of liabilities in the business combination:

   i. a description of each transaction;

   ii. how the acquirer accounted for each transaction;

   iii. the amounts recognised for each transaction and the line item in the financial statements in which each amount is recognised; and

   iv. if the transaction is the effective settlement of a pre-existing relationship, the method used to determine the settlement amount.

m. the disclosure of separately recognised transactions required by (l) shall include the amount of acquisition-related costs and, separately, the amount of those costs recognised as an expense and the line item or items in the statement of profit and loss in which those expenses are recognised. The amount of any issue costs not recognised as an expense and how they were recognised shall also be disclosed.

n. in a bargain purchase (see paragraphs 34–36A):

   i. the amount of any gain recognised in other comprehensive income in accordance with paragraph 34;

   ii. the amount of any gain directly recognised in equity in accordance with paragraph 36A; and

   iii. a description of the reasons why the transaction resulted in a gain in case of (i) above.

o. for each business combination in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at the acquisition date:

   i. the amount of the non-controlling interest in the acquiree recognised at the acquisition date and the measurement basis for that amount; and

   ii. for each non-controlling interest in an acquiree measured at fair value, the valuation technique(s) and significant inputs used to measure that value.

p. in a business combination achieved in stages:

   i. the acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the acquisition date; and

   ii. the amount of any gain or loss recognised as a result of remeasuring to fair value the equity interest in the acquiree held by the acquirer before the business combination (see paragraph 42) and the line item in the statement of profit and loss in which that gain or loss is recognised.

q. Following additional information:

   i. the amounts of revenue and profit or loss of the acquiree since the acquisition date included in the consolidated statement of profit and loss for the reporting period; and

   ii. the revenue and profit or loss of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period.

If disclosure of any of the information required by this subparagraph is impracticable, the acquirer shall disclose that fact and explain why the disclosure is impracticable. This Ind AS uses the term 'impracticable' with the same meaning as in Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors.

If the acquisition date of a business combination is after the end of the reporting period but before the financial statements are approved for issue, the acquirer shall disclose the information required as above unless the initial accounting for the business combination is incomplete at the time the financial statements are approved for issue. In that situation, the acquirer shall describe which disclosures could not be made and the reasons why they cannot be made.

To meet the objective of the Ind AS 103 disclosure requirement, the acquirer shall disclose the following information for each material business combination or in the aggregate for individually immaterial business combinations that are material collectively:

a) if the initial accounting for a business combination is incomplete for particular assets, liabilities, non-controlling interests or items of consideration and the amounts recognised in the financial statements for the business combination thus have been determined only provisionally

   i. the reasons why the initial accounting for the business combination is incomplete;

   ii. the assets, liabilities, equity interests or items of consideration for which the initial accounting is incomplete; and

   iii. the nature and amount of any measurement period adjustments recognised during the reporting period.

b) for each reporting period after the acquisition date until the entity collects, sells or otherwise loses the right to a contingent consideration asset, or until the entity settles a contingent consideration liability or the liability is cancelled or expires:

i. any changes in the recognised amounts, including any differences arising upon settlement;

ii. any changes in the range of outcomes (undiscounted) and the reasons for those changes; and

iii. the valuation techniques and key model inputs used to measure contingent consideration.

c) for contingent liabilities recognised in a business combination, the acquirer shall disclose the information required by paragraphs 84 and 85 of Ind AS 37 for each class of provision.

d) a reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period showing separately:

i. the gross amount and accumulated impairment losses at the beginning of the reporting period.

ii. additional goodwill recognised during the reporting period, except goodwill included in a disposal group that, on acquisition, meets the criteria to be classified as held for sale in accordance with Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations.

iii. adjustments resulting from the subsequent recognition of deferred tax assets during the reporting period

iv. goodwill included in a disposal group classified as held for sale in accordance with Ind AS 105 and goodwill derecognised during the reporting period without having previously been included in a disposal group classified as held for sale

v. impairment losses recognised during the reporting period in accordance with Ind AS 36. (Ind AS 36 requires disclosure of information about the recoverable amount and impairment of goodwill in addition to this requirement.)

vi. net exchange rate differences arising during the reporting period in accordance with Ind AS 21, The Effects of Changes in Foreign Exchange Rates.

vii. any other changes in the carrying amount during the reporting period.

viii. the gross amount and accumulated impairment losses at the end of the reporting period.

e) the amount and an explanation of any gain or loss recognised in the current reporting period that both:

i. relates to the identifiable assets acquired or liabilities assumed in a business combination that was effected in the current or previous reporting period; and

ii. is of such a size, nature or incidence that disclosure is relevant to understanding the combined entity's financial statements.

The acquirer shall disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognised in the current reporting period that relate to business combinations that occurred in the period or previous reporting periods.

15. COMMON CONTROL TRANSACTIONS INCLUDING MERGER

Common control transaction accounting guidance is included in Appendix C of Ind AS 103.

15.1 Definitions

Transferor means an entity or business which is combined into another entity as a result of a business combination.

Transferee means an entity in which the transferor entity is combined.

Reserve means the portion of earnings, receipts or other surplus of an entity (whether capital or revenue) appropriated by the management for a general or a specific purpose other than provision for depreciation.

Common control business combination means a business combination involving entities or businesses in which all the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

15.2 Common Control Business Combinations

Common control business combinations will include transactions, such as transfer of subsidiaries or businesses, between entities within a group.

The extent of non-controlling interests in each of the combining entities before and after the business combination is not relevant to determining whether the combination involves entities under common control. This is because a partially-owned subsidiary is nevertheless under the control of the parent entity.

An entity can be controlled by an individual, or by a group of individuals acting together under a ***contractual arrangement***, and that individual or group of individuals may not be subject to the financial reporting requirements of Ind AS. Therefore, it is not necessary for combining entities to be included as part of the same consolidated financial statements for a business combination to be regarded as one having entities under common control.

A group of individuals are regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities, and that ultimate collective power is not transitory.

Common control combinations are the most frequent. Broadly, these are transactions in which an entity obtains control of a business (hence a business combination) but both combining parties are ultimately controlled by the same party or parties both before and after the combination. These combinations often occur as a result of a group reorganisation in which the direct ownership of subsidiaries changes but the ultimate parent remains the same. However, such combinations can also occur in other ways and careful analysis and judgement are sometimes required to assess whether some combinations are covered by the definition (and the scope exclusion). In particular:

- an assessment is required as to whether common control is 'transitory' (if so, the combination is not a common control combination and Ind AS 103 applies). The term transitory is not explained in the standard. In our view it is intended to ensure that Ind AS 103 is applied when a transaction that will lead to a substantive change in control is structured such that, for a brief period before and after the combination, the entity to be acquired/sold is under common control. However, common control should not be considered transitory simply because a combination is carried out in contemplation of an initial public offering or sale of combined entities.
- when a group of two or more individuals has control before and after the transaction, an assessment is needed as to whether they exercise control collectively as a result of a contractual agreement.

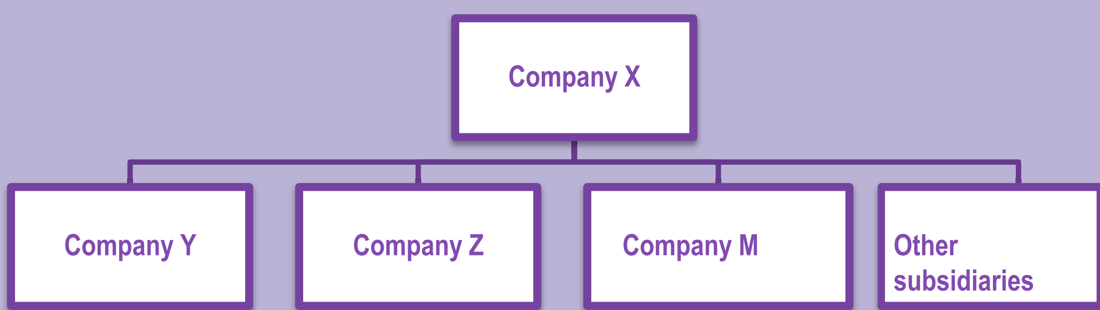
  Examples of common control transaction

  - Merger between fellow subsidiaries
  - Merger of subsidiary with parent
  - Acquisition of an entity from an entity within the same group
  - Bringing together entities under common control in a corporate legal structure

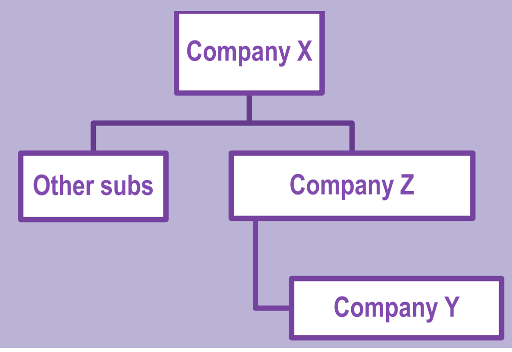
Illustration 28

Company X, the ultimate parent of a large number of subsidiaries, reorganises the retail segment of its business to consolidate all of its retail businesses in a single entity. Under the reorganisation, Company Z (a subsidiary and the biggest retail company in the group) acquires Company X's shareholdings in its one operating subsidiary, Company Y by issuing its own shares to Company X. After the transaction, Company X will directly control the operating and financial policies of Companies Y.

Before-Reorganisation



After- Reorganisation



Solution

In this situation, Company Z pays consideration to Company X to obtain control of Company Y. The transaction meets the definition of a business combination. Prior to the reorganisation, each of the parties are controlled by Company X. After the reorganisation, although Company Y are now owned by Company Z, all two companies are still ultimately owned and controlled by Company X. From the perspective of Company X, there has been no change as a result of the reorganisation. This transaction therefore meets the definition of a common control combination and is within the scope of Ind AS 103.

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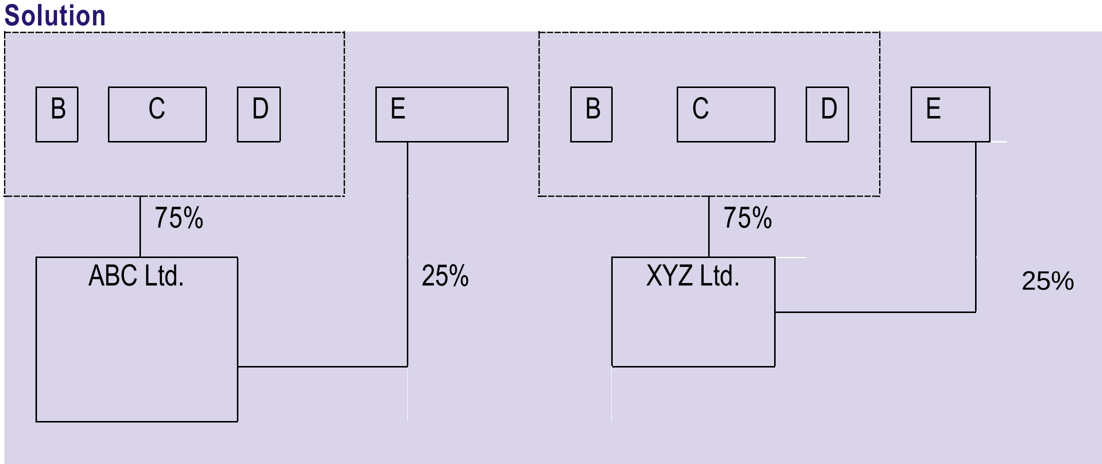
Illustration 29

ABC Ltd. and XYZ Ltd. are owned by four shareholders B, C, D and E, each of whom holds 25% of the shares in each company. Shareholders B, C and D have entered into a shareholders' agreement in terms of governance of ABC Ltd. and XYZ Ltd. due to which they exercise joint control.

Whether ABC Ltd. and XYZ Ltd. are under common control?

Solution



Appendix C to Ind AS 103 defines common control business combination as a business combination involving entities or businesses in which all the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

As per paragraphs 6 and 7 of Appendix C to Ind AS 103, an entity can be controlled by an individual, or by a group of individuals acting together under a contractual arrangement, and that individual or group of individuals may not be subject to the financial reporting requirements of Ind AS. Therefore, it is not necessary for combining entities to be included as part of the same consolidated financial statements for a business combination to be regarded as one having entities under common control. Also, a group of individuals are regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities, and that ultimate collective power is not transitory.

In the instant case, both ABC Ltd. and XYZ Ltd. are jointly controlled by group of individuals (B, C and D) as a result of contractual arrangement. Therefore, in the current scenario, ABC Ltd. and XYZ Ltd. are considered to be under common control.

*****

Illustration 30

ABC Ltd. and XYZ Ltd. are owned by four shareholders B, C, D and E, each of whom holds 25% of the shares in each company. However, there are no agreements between any of the shareholders that they will exercise their voting power jointly.

Whether ABC Ltd. and XYZ Ltd. are under common control?

Solution

Appendix C to Ind AS 103 defines 'Common control business combination' as business combination involving entities or businesses in which all the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

Further as per paragraphs 6 and 7 of Appendix C to Ind AS 103, an entity can be controlled by an individual, or by a group of individuals acting together under a contractual arrangement, and that individual or group of individuals may not be subject to the financial reporting requirements of Ind AS. Therefore, it is not necessary for combining entities to be included as part of the same consolidated financial statements for a control. Also a group of individuals are regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities, and that ultimate collective power is not transitory.

In the present case, there is no contractual arrangement between the shareholders who exercise control collectively over either company. Thus, ABC Ltd. and XYZ Ltd. are not considered to be under common control even if there is an established pattern of voting together.

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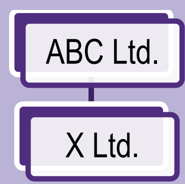
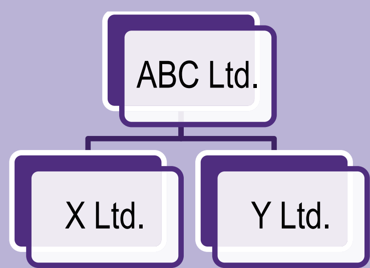
Illustration 31

ABC Ltd. had a subsidiary, namely, X Ltd. which was acquired on 1st April, 2XX0. ABC Ltd. acquires all of the shares of Y Ltd. on 1st April, 2X17. ABC Ltd. transfers the shares in Y Ltd. to X Ltd. on 2nd April, 2X17. How should the above transfer of Y Ltd. into X Ltd. be accounted for in the consolidated financial statements of X Ltd.?

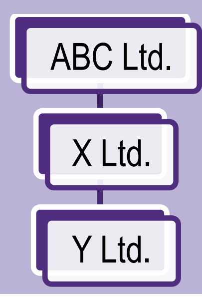
Before:



Intermediate:



After:



Solution

Appendix C to Ind AS 103 defines common control business combination as business combination involving entities or businesses in which all the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

As per paragraph 7 of Appendix C to Ind AS 103, a group of individuals are regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities, and that ultimate collective power is not transitory.

The term 'transitory' has been included as part of Appendix C to Ind AS 103.

The word 'transitory' has been included in the common control definition to ensure that acquisition accounting applies to those transactions that look as though they are combinations involving entities under common control, but which in fact represent genuine substantive business combinations with unrelated parties.

Based on above, if the intermediate step had been omitted and instead X Ltd. had been the ABC group's vehicle for the acquisition of Y Ltd. - i.e. going straight to the 'after' position - then X Ltd. would have been identified as the acquirer.

Considering X Ltd. and Y Ltd. are under common control (with common parent), it might seem that acquisition accounting is not required because of the specific requirement for common control business combination. However, X Ltd. should be identified as the acquirer and should account for its combination with Y Ltd. using acquisition accounting. This is because X Ltd. would have applied acquisition accounting for Y Ltd. if X Ltd. had acquired Y Ltd directly rather than through ABC Ltd. Acquisition accounting cannot be avoided in the financial statements of X Ltd. simply by placing X Ltd. and Y Ltd. under the common control of P shortly before the transaction.

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15.3 Method of Accounting for Common Control Business Combinations

Business combinations involving entities or businesses under common control shall be accounted for using the pooling of interest method.

The pooling of interest method is considered to involve the following:

(i) The assets and liabilities of the combining entities are reflected at their carrying amounts.

(ii) No adjustments are made to reflect fair values, or recognise any new assets or liabilities. The only adjustments that are made are to harmonise accounting policies.

(iii) The financial information in the financial statements in respect of prior periods should be restated as if the business combination had occurred from the beginning of the earliest period presented in the financial statements, irrespective of the actual date of the combination. However, if business combination had occurred after that date, the prior period information shall be restated only from that date.

The consideration for the business combination may consist of securities, cash or other assets. Securities shall be recorded at nominal value. In determining the value of the consideration, assets other than cash shall be considered at their fair values.

The balance of the retained earnings appearing in the financial statements of the transferor is aggregated with the corresponding balance appearing in the financial statements of the transferee. Alternatively, it is transferred to General Reserve, if any.

The identity of the reserves shall be preserved and shall appear in the financial statements of the transferee in the same form in which they appeared in the financial statements of the transferor. Thus, for example, the General Reserve of the transferor entity becomes the General Reserve of the transferee, the Capital Reserve of the transferor becomes the Capital Reserve of the transferee and the Revaluation Reserve of the transferor becomes the Revaluation Reserve of the transferee. As a result of preserving the identity, reserves which are available for distribution as dividend before the business combination would also be available for distribution as dividend after the business combination.

The difference, if any, between the amount recorded as share capital issued plus any additional consideration in the form of cash or other assets and the amount of share capital of the transferor shall be transferred to capital reserve and should be presented separately from other capital reserves with disclosure of its nature and purpose in the notes.

The acid test in assessing common control transaction is that before and after the reorganisation the entity should be controlled by the same shareholders.

16. SIGNIFICANT DIFFERENCES BETWEEN IND AS 103 AND AS 14

- **Under the existing Indian GAAP**, there is no comprehensive standard that addresses accounting for acquisitions where one entity obtains control of another entity. The accounting for such transactions is largely dependent on the form of the acquisition. For example, the accounting treatment may differ depending on whether the acquired company is retained as a separate legal entity or whether it is legally merged with the acquirer.

  To add to the complexity and confusion, if the acquired company is merged with the acquirer through a court-approved scheme, the scheme itself may prescribe an accounting treatment that is required to be followed, which may be in variation with the accounting standards. Indian GAAP still permits the use of the pooling-of-interest method whereby the entire transaction is accounted based on carrying values and no goodwill arises.

  Further, the current principles (AS 21, Consolidated Financial Statements) provide guidance on accounting for acquisition of a subsidiary in the entity's consolidated financial statements by adding, on a line-by-line basis, all assets and liabilities of the acquiree at the carrying values as appearing in the acquiree's financial statement (subject to adjustment for alignment of accounting policies).

- **Under Ind AS 103,** Business Combination, is a more widely used term than just in relation to mergers and amalgamations and encompasses a wide range of arrangements (unless excluded from scope of Ind AS 103). Ind AS 103 provides principles for identifying what constitutes a business combination, prescribes the accounting treatment for business combinations with greater emphasis on the use of fair values in accounting for a business combination.

  The core principle of Ind AS 103 requires an acquirer of a business to recognise the assets acquired and the liabilities assumed at their acquisition date fair values and to disclose information that enables users to evaluate the nature and financial effects of the acquisition.

S. No.	Basis	Ind AS	Accounting Standards
1.	**Primary guidance**	Ind AS 103 "Business Combinations"	AS 14 "Accounting for Amalgamation", AS 21 "Consolidated Financial Statements" **Note:** There is no specific guidance. which comprehensively covers all types of business combination transactions
		Business combinations are accounted for in compliance with Ind AS 103.	The transactions that meet the definition of amalgamations under the Companies Act are accounted for in compliance with AS 14. Parent's equity interest in a subsidiary as at the date of acquisitions accounted for in compliance with AS 21 in the consolidated financial statements of the parent.
2.	**Amalgamations**	• All business combinations are accounted by using the acquisition method with limited exceptions. • All identifiable assets and liabilities are recognised and measured at acquisition date fair values with limited exceptions. • Purchase consideration is recognised at acquisition date fair value. • Non-controlling interests in the acquiree is measured either at fair value or at the non-controlling interest's proportionate share of the	▪ **Amalgamation in the nature of purchase:** Either identifiable assets and liabilities recorded at their existing carrying amount or fair value at the date of amalgamation ▪ **Amalgamations in the nature of merger:** Accounted under 'Pooling of interests method' where the assets, liabilities and reserves of the

S. No.	Basis	Ind AS	Accounting Standards
		acquiree's identifiable net assets. • Pooling of interests method to record business combination is prohibited.	transferor company are recorded by transferee company at their existing carrying amount. ▪ **Others:** • In case of transaction that do not meet the definition of amalgamation, assets and liabilities of acquiree are recorded in the consolidated financial statements at their existing carrying amounts on the date of acquisition.
3.	**Asset acquisition**	Similar to Indian GAAP.	The transactions that do not meet the definition of amalgamation / acquisition of a subsidiary, are accounted as asset acquisitions without any goodwill or capital reserve recognised separately and the consideration is apportioned to the various assets on a fair value basis as determined by competent valuers.
4.	**Acquisition related costs**	Acquisition related costs such as finder's fee, due diligence costs, etc. are expensed as incurred.	There is no specific guidance, but they are generally capitalised.

S. No.	Basis	Ind AS	Accounting Standards
5.	**Goodwill or capital reserve (gain on bargain purchase)**	Gain on bargain purchase is recognised in OCI if there is sufficient evidence that shows the appropriateness of bargain purchase gain.	Difference between the purchase consideration and the net assets acquired is recorded as goodwill or capital reserve (presented as equity) as the case may be.
		Goodwill is not amortised but tested for impairment annually.	Goodwill arising on amalgamation is amortised over its useful life not exceeding five years unless a longer period is justified. There is no specific guidance on goodwill arising on subsidiaries acquired which are not amalgamations. In practice, such goodwill is not amortised but tested for impairment.

6.	**Contingent consideration**	▪ Initially recognised at acquisition date fair value
		▪ Subsequent measurement
		  ▪ Contingent consideration classified as equity is not remeasured.
		  ▪ Contingent consideration classified as liability generally remeasured at fair value with changes at every reporting period end until settlement, with changes in fair value
			Contingent consideration is included in the purchase consideration as at the date of amalgamation, if payment is probable and a reasonable estimate of the amount can be made. In other cases, the adjustment is recognised in the profit and loss account as and when it becomes determinable.
			Others:
			▪ There is no specific guidance. In

S. No.	Basis	Ind AS	Accounting Standards
		recognised in profit or loss.	practice, contingent consideration is recognised when the contingency is resolved.
7.	**In-process research and development**	▪ Initially recognised at acquisition date fair value. ▪ Subsequently measured in accordance with Ind AS 38.	▪ There is no specific guidance.
8.	**Measurement period**	Ind AS 103 provides for a measurement period after the acquisition date for the acquirer to adjust the provisional amounts recognised to reflect the additional information that existed as at the date of acquisition. The measurement period is limited to one year from the acquisition date.	There is no specific guidance.
9.	**Business combination achieved in stages (step acquisition)**	Any equity interest in the acquiree held by the acquirer immediately before the obtaining control over the acquiree is adjusted to acquisition-date fair value. Any resulting gain or loss is recognised in the profit or loss.	If two or more investments are made over a period of time, the equity of the subsidiary at the date of investment is generally determined on a step-by-step basis.
10.	**Transactions between entities under common control**	Appendix C to Ind AS 103 provides detailed guidance on which is very similar to the pooling of interest method as specified by AS 14.	There is no specific guidance. In practice, the accounting is generally determined by the scheme approved through a court order.

Illustration 32

Enterprise Ltd. has 2 divisions Laptops and Mobiles. Division Laptops has been making constant profits while division Mobiles has been invariably suffering losses.

On 31st March, 20X2, the division-wise draft extract of the Balance Sheet was:

(₹ in crores)

		Laptops	Mobiles	Total
Property, Plant and Equipment cost		250	500	750
Depreciation		(225)	(400)	(625)
Net Property, Plant and Equipment	(A)	25	100	125
Current assets:		200	500	700
Less: Current liabilities		(25)	(400)	(425)
	(B)	175	100	275
Total	(A+B)	200	200	400
Financed by:				
Loan funds		-	300	300
Capital : Equity ₹ 10 each		25	-	25
Surplus		175	(100)	75
		200	200	400

Division Mobiles along with its assets and liabilities was sold for ₹ 25 crores to Turnaround Ltd. a new company, who allotted 1 crore equity shares of ₹ 10 each at a premium of ₹ 15 per share to the members of Enterprise Ltd. in full settlement of the consideration, in proportion to their shareholding in the company. One of the members of the Enterprise Ltd. was holding 52% shareholding of the Company.

Assuming that there are no other transactions, you are asked to:

(i) Pass journal entries in the books of Enterprise Ltd.

(ii) Prepare the Balance Sheet of Enterprise Ltd. after the entries in (i).

(iii) Prepare the Balance Sheet of Turnaround Ltd.

Solution

Journal of Enterprise Ltd.

(₹ in crores)

			Dr.	Cr.
(1)	Loan Funds	Dr.	300	
	Current Liabilities	Dr.	400	

	Provision for Depreciation	Dr.	400	
	To Property, Plant and Equipment			500
	To Current Assets			500
	To Capital Reserve			100
	(Being division Mobiles along with its assets and liabilities sold to Turnaround Ltd. for ₹ 25 crores)			

Notes :

(1) Any other alternative set of entries, with the same net effect on various accounts, may be given by the students.

(2) In the given scenario, this demerger will meet the definition of common control transaction. Accordingly, the transfer of assets and liabilities will be derecognized and recognized as per book value and the resultant loss or gain will be recorded as capital reserve in the books of demerged entity (Enterprise Ltd).

Enterprise Ltd.

Balance Sheet after reconstruction ***(₹ in crores)***

ASSETS	Note No.	Amount
Non-current assets		
Property, Plant and Equipment		25
Current assets		
Other current assets		200
		225
EQUITY AND LIABILITIES		
Equity		
Equity share capital (of face value of ₹ 10 each)		25
Other equity (Surplus)		175
Liabilities		
Current liabilities		
Current liabilities		25
		225

Notes to Accounts

		(₹ in crores)
1.	**Other Equity**	
	Surplus (175-100)	75
	Add: Capital Reserve on reconstruction	100
		175

Notes to Accounts: Consequent on transfer of Division Mobiles to newly incorporated company Turnaround Ltd., the members of the company have been allotted 1 crore equity shares of ₹ 10 each at a premium of ₹ 15 per share of Turnaround Ltd., in full settlement of the consideration in proportion to their shareholding in the company.

Balance Sheet of Turnaround Ltd.

(₹ in crores)

ASSETS	Note No.	Amount
Non-current assets		
Property, Plant and Equipment		100
Current assets		
Other current assets		500
		600
EQUITY AND LIABILITIES		
Equity		
Equity share capital (of face value of ₹ 10 each)	1	10
Other equity	2	(110)
Liabilities		
Non-current liabilities		
Financial liabilities		
Borrowings		300
Current liabilities		
Current liabilities		400
		600

Notes to Accounts

		(₹ in crores)
1.	**Share Capital:**	
	Issued and Paid-up capital	
	1 crore Equity shares of ₹ 10 each fully paid up	10
	(All the above shares have been issued for consideration other than cash, to the members of Enterprise Ltd. on takeover of Division Mobiles from Enterprise Ltd.)	
2.	**Other Equity:**	
	Securities Premium	15
	Capital reserve [25- (600 – 700)]	(125)
		(110)

Working Note:

In the given case, since both the entities are under common control, this will be accounted as follows:

- All assets and liabilities will be recorded at book value
- Identity of reserves to be maintained.
- No goodwill will be recorded.
- Securities issued will be recorded as per the nominal value.

Illustration 33

Maxi Mini Ltd. has 2 divisions - Maxi and Mini. The draft information of assets and liabilities as at 31st October, 20X2 was as under:

	Maxi division	Mini division	Total (in crores)
Property, Plant and Equipment			
Cost	600	300	900
Depreciation	(500)	(100)	(600)
W.D.V. (A)	100	200	300
Current assets	400	300	700
Less: Current liabilities	(100)	(100)	(200)
(B)	300	200	500
Total (A+B)	400	400	800
Financed by :			
Loan funds (A)	–	100	100
(secured by a charge on property, plant and equipment)			
Own funds:			
Equity capital			50
(fully paid up ₹ 10 per share)			
Other Equity			650
(B)	?	?	700
Total (A+B)	400	400	800

It is decided to form a new company Mini Ltd. to take over the assets and liabilities of Mini division.

Accordingly, Mini Ltd. was incorporated to take over at Balance Sheet figures, the assets and liabilities of that division. Mini Ltd. is to allot 5 crore equity shares of ₹ 10 each in the company to the members of Maxi Mini Ltd. in full settlement of the consideration. The members of Maxi Mini Ltd. are therefore to become members of Mini Ltd. as well without having to make any further investment.

(a) You are asked to pass journal entries in relation to the above in the books of Maxi Mini Ltd. and Mini Ltd. Also show the Balance Sheets of the 2 companies as on the morning of 1st November, 20X2, showing corresponding previous year's figures.

(b) The directors of the 2 companies ask you to find out the net asset value of equity shares pre and post demerger.

(c) Comment on the impact of demerger on "share holders wealth".

Solution

Demerged Company: Mini Division of "Maxi Mini Ltd"

Resulting Company: "Mini Ltd."

(a) Journal of Maxi Mini Ltd. (Demerged Company)

		(₹ in crores)	
		Dr.	**Cr.**
Current liabilities A/c	Dr.	100	
Loan fund (secured) A/c	Dr.	100	
Provision for depreciation A/c	Dr.	100	
Loss on reconstruction (Balancing figure)	Dr.	300	
To Property, Plant and Equipment A/c			300
To Current assets A/c			300
(Being the assets and liabilities of Mini division taken out of the books on transfer of the division to Mini Ltd., the consideration being allotment to the members of the company of one equity share of ₹ 10 each of that company at par for every share held in the company vide scheme of reorganisation)			

Note : Any other alternatives set of entries, with the same net effect on various accounts, may be given by the students. In the absence of additional information on fair value of the assets transferred it has been assumed that the group of shareholders control both the demerged and the resultant entity. It is expected that students should evaluate all reorganization from common control parameters and aptly highlight the assumptions in the note while solving the question.

Journal of Mini Ltd.

		(₹ in crores)	
		Dr.	**Cr.**
Property, Plant and Equipment (300-100) A/c	Dr.	200	
Current assets A/c	Dr.	300	
To Current Liabilities A/c			100
To Secured loan funds A/c			100
To Equity share capital A/c			50
To Capital reserve			250
(Being the assets and liabilities of Mini division of Maxi Mini Ltd. taken over and allotment of 5 crores equity shares of ₹ 10 each at part as fully paid up to the members of Maxi Mini Ltd.)			

Maxi Mini Ltd.

Balance Sheet as at 1st November, 20X2

₹ in crore

ASSETS	**Note No.**	**After Reconstruction**	**Before Reconstruction**
Non-current assets			
Property, Plant and Equipment	2	100	300
Current assets			
Other current assets		400	700
		500	1,000
EQUITY AND LIABILITIES			
Equity			
Equity share capital (of face value of ₹ 10 each)		50	50
Other equity	1	350	650
Liabilities			
Non-current liabilities			
Financial liabilities			
Borrowings		-	100
Current liabilities			
Current liabilities		100	200
		500	1,000

Notes to Accounts

		After Reconstruction	*Before Reconstruction*
1.	**Other Equity**		
	Other Equity	650	650
	Less: Loss on reconstruction	(300)	–
		350	650
2.	**Property, Plant and Equipment**	600	900
	Less: Depreciation	(500)	(600)
		100	300

Notes to Accounts: Consequent on reconstruction of the company and transfer of Mini division to newly incorporated company Mini Ltd., the members of the company have been allotted 5 crores equity shares of ₹ 10 each at part of Mini Ltd. The demerged entity and the resultant entity are common control and accordingly the transaction has been accounted at book values of the assets transferred in both the entity.

Mini Ltd.

Balance Sheet as at 1st November, 20X2 ***₹ in crore***

ASSETS	**Note No.**	**After reconstruction**
Non-current assets		
Property, Plant and Equipment		200
Current assets		
Other current assets		300
		500
EQUITY AND LIABILITIES		
Equity		
Equity share capital (of face value of ₹ 10 each)		50
Other equity (capital reserve)		250
Liabilities		
Non-current liabilities		
Financial liabilities		
Borrowings		100
Current liabilities		
Current liabilities		100
		500

Notes to Account

	(₹ in crores)
1. Share Capital:	
Issued and paid up :	
5 crores Equity shares of ₹ 10 each fully paid up	50
(All the above shares have been issued for consideration other than cash, to the members of Maxi Mini Ltd., on takeover of Mini division from Maxi Mini Ltd.)	

(b) Net asset value of an equity share

	Pre-demerger	*Post-demerger*
Maxi Mini Ltd. :	$\frac{₹\ 700 \text{ crores}}{5 \text{ crores}} = ₹\ 140$	$\frac{₹\ 400 \text{ crores}}{5 \text{ crores}} = ₹\ 80$
Mini Ltd.:		$\frac{₹\ 300 \text{ crores}}{5 \text{ crores}} = ₹\ 60$

(c) Demerger into two companies has had no impact on "net asset value" of shareholding. Pre-demerger, it was ₹ 140 per share. After demerger, it is ₹ 80 plus ₹ 60 i.e. ₹ 140 per original share.

It is only yield valuation that is expected to change because of separate focusing on two distinct businesses whereby profitability is likely to improve on account of demerger.

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Illustration 34

AX Ltd. and BX Ltd. amalgamated on and from 1st January, 20X2. A new Company ABX Ltd. with shares of ₹ 10 each was formed to take over the businesses of the existing companies.

Summarized Balance Sheet as on 31-12-20X2

₹ in '000

ASSETS	***Note No.***	***AX Ltd***	***BX Ltd***
Non-current assets			
Property, Plant and Equipment		*8,500*	*7,500*
Financial assets			
Investment		*1,050*	*550*
Current assets			
Inventory		*1,250*	*2,750*
Trade receivables		*1,800*	*4,000*
Cash and Cash equivalent		*450*	*400*
		13,050	*15,200*

EQUITY AND LIABILITIES			
Equity			
Equity share capital (of face value of ₹ 10 each)		6,000	7,000
Other equity	1	3,050	2,700
Liabilities			
Non-current liabilities			
Financial liabilities			
Borrowings (12% Debentures)		3,000	4,000
Current liabilities			
Trade payables		1,000	1,500
		13,050	15,200

Note:

1.	Other equity	AX Ltd	BX Ltd
	General Reserve	1,500	2,000
	Profit & Loss	1,000	500
	Investment Allowance Reserve	500	100
	Export Profit Reserve	50	100
		3,050	2,700

ABX Ltd. issued requisite number of shares to discharge the claims of the equity shareholders of the transferor companies. Also the new debentures were issued in exchange of the old series of both the companies.

Prepare a note showing purchase consideration and discharge thereof and draft the Balance Sheet of ABX Ltd:

a. *Assuming that both the entities are under common control*

b. *Assuming BX Ltd is a larger entity and their management will take the control of the entity ABX Ltd.*

The fair value of net assets of AX and BX limited are as follows:

Assets	AX Ltd. ('000)	BX Ltd. ('000)
Property, Plant and Equipment	9,500	1,000
Inventory	1,300	2,900
Fair value of the business	11,000	14,000

Solution

(a) (Assumption: Common control transaction)

1. Calculation of Purchase Consideration

		AX Ltd.		BX Ltd.
		₹ '000		₹ '000
Assets taken over:				
Property, Plant and Equipment		85,00		75,00
Investment		10,50		5,50
Inventory		12,50		27,50
Trade receivables		18,00		40,00
Cash & Cash equivalent		4,50		4,00
Gross Assets		130,50		152,00
Less : Liabilities				
12% Debentures	30,00		40,00	
Trade payables	10,00	(40,00)	15,00	(55,00)
Net Assets taken over		90,50		97,00
Less: Other Equity:				
General Reserve	15,00		20,00	
P & L A/c	10,00		5,00	
Investment Allowance Reserve	5,00		1,00	
Export Profit Reserve	50	(30,50)	1,00	(27,00)
Purchase Consideration		60,00		70,00

Total Purchase Consideration = 130,00 (60,00 of AX Ltd. & 70,00 of BX Ltd.)

2. Discharge of Purchase Consideration

No. of shares to be issued to AX Ltd =

$$\frac{\text{Net Assets taken over of AX Ltd.}}{\text{Net Assets taken over of AX Ltd. and BX Ltd.}} \text{x Purchase Consideration}$$

No. of shares to be issued to BX Ltd =

$$\frac{\text{Net Assets taken over of BX Ltd.}}{\text{Net Assets taken over of AX Ltd. and BX Ltd.}} \text{x Purchase Consideration}$$

	AX Ltd. ₹'000	BX Ltd. ₹'000
$130,00 \times \frac{90,50}{187,50} = 6,27,500$ * Equity shares of ₹ 10 each	62,75	
$130,00 \times \frac{97,00}{187,50} = 6,72,500$ Equity shares of ₹ 10 each		67,25

Balance Sheet of ABX Ltd. as on 1.1.20X2

₹ in '000

ASSETS	Note No.	Amount
Non-current assets		
Property, Plant and Equipment		16,000
Financial assets		
Investments		1,600
Current assets		
Inventory		4,000
Trade receivable		5,800
Cash and Cash equivalent		850
		28,250
EQUITY AND LIABILITIES		
Equity		
Equity share capital (of face value of ₹ 10 each)	1	13,000
Other equity	2	5,750
Liabilities		
Non-current liabilities		
Financial liabilities		
Borrowings	3	7,000
Current liabilities		
Trade payable		2,500
		28,250

* The total purchase consideration is to be discharged by ABX Ltd. in such a way that the rights of the shareholders of AX Ltd. and BX Ltd. remain unaltered in the future profits of ABX Ltd.

Notes to Accounts

		(₹ 000)	(₹ 000)
1.	**Share Capital**		
	13,00,000 Equity Shares of ₹ 10 each		130,00
2.	**Other Equity**		
	General Reserve (15,00 + 20,00)	35,00	
	Profit & Loss (10,00 + 5,00)	15,00	
	Investment Allowance Reserve (5,00 + 1,00)	6,00	
	Export Profit Reserve (50 + 1,00)	1,50	57,50
3.	**Long Term Borrowings**		
	12% Debentures		70,00

(b) Assuming BX Ltd is a larger entity and their management will take the control of the entity ABX Ltd.

In this case BX Ltd. and AX Ltd. are not under common control and hence accounting prescribed under Ind AS 103 for business combination will be applied. A question arises here is who is the accounting acquirer ABX Ltd which is issuing the shares or AX Ltd. or BX Ltd. As per the accounting guidance provided in Ind AS 103, sometimes the legal acquirer may not be the accounting acquirer. In the given scenario although ABX Ltd. is issuing the shares but BX Ltd. post-merger will have control and is bigger in size which is a clear indicator that BX Ltd. will be an accounting acquirer. This can be justified by the following table:

(In '000s)

	AX Ltd.	BX Ltd.
Fair Value	11,000	14,000
Value per share	10	10
No. of shares	1,100	1,400
i.e. Total No. of shares in ABX Ltd. = 2,500 thousand shares		
Thus, % Held by each Company in Combined Entity	44%	56%

Note: It is a case of Reverse Acquisition.

Accordingly, BX Ltd. assets will be recorded at historical cost in the merged financial statements.

(1) Calculation of Purchase Consideration (All figures are in thousands)

We need to calculate the number of shares to be issued by BX Ltd. to AX Ltd. to maintain the same percentage i.e. 56%:

Thus, 700 thousand shares of BX Ltd. (given in the balance sheet) represents 56%. This means that total no. of shares would be 1,250 thousand shares ie 700 thousand shares / 56%.

This implies BX Ltd. would need to issue 550 thousand shares (1,250 less 700) to AX Ltd.

Purchase Consideration = 550 thousand shares x ₹ 20 per share (ie. 14,000 thousand / 700 thousand shares) = ₹ 11,000 thousand.

Balance Sheet of ABX Ltd. as on 1.1.20X2

₹ in '000

ASSETS	Note No.	Amount
Non-current assets		
Goodwill (Refer Working Note)		900
Property, Plant and Equipment (9500+7500)		17,000
Financial assets		
Investment (1050+550)		1,600
Current assets		
Inventory (1300+2750)		4,050
Trade receivables (1800+4000)		5,800
Cash and Cash equivalent (450+400)		850
		30,200
EQUITY AND LIABILITIES		
Equity		
Equity share capital (of face value of ₹ 10 each)	1	12,500
Other equity	2	8,200
Liabilities		
Non-current liabilities		
Financial liabilities		
Borrowings (12% Debentures)	3	7,000
Current liabilities		
Trade payables		2,500
		30,200

Notes to Accounts

		(₹ 000)	(₹ 000)
1.	**Share Capital**		

	1,250,000 Equity Shares of ₹ 10 each (700,000 to BX Ltd and 550,000 as computed above to AX LTD)		1,25,00
2.	**Other Equity**		
	General reserve of BX Ltd	20,00	
	P&L of BX Ltd	5,00	
	Export Profit Reserve of BX Ltd	1,00	
	Investment Allowance Reserve of BX Ltd	1,00	
	Security Premium (550 shares x 10)	5,500	8,200
3.	**Long Term Borrowings**		
	12% Debentures		70,00

Working Note:

Goodwill Computation:

Assets:	**₹ in 000s**
Property, Plant and Equipment	9,500
Investment	1,050
Inventory	1,300
Trade Receivable	1,800
Cash & Cash Equivalent	450
Total Assets	14,100
Less : Liabilities:	
Borrowings	3,000
Trade Payable	1,000
Net Assets	10,100
Purchase Consideration	11,000
Goodwill	900

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Illustration 35

On 9th April, 20X2, Shyam Ltd. a listed company started to negotiate with Ram Ltd, which is an unlisted company about the possibility of merger. On 10th May, 20X2, the board of directors of Shyam Ltd. authorized their management to pursue the merger with Ram Ltd. On 15th May, 20X2, management of Shyam Ltd. offered management of Ram Ltd. 12,000 shares of Shyam Ltd. against their total share outstanding. On 31st May, 20X2, the board of directors of Ram Ltd accepted the offer subject to shareholder's vote. On 2nd June, 20X2 both the companies jointly made a press release about the proposed merger.

On 10th June, 20X2, the shareholders of Ram Ltd approved the terms of the merger. On 15th June, the shares were allotted to the shareholders of Ram Ltd.

The market price of the shares of Shyam Ltd was as follows:

Date	Price per share
9th April	70
10th May	75
15th May	60
31st May	70
2nd June	80
10th June	85
15th June	90

What is the acquisition date and what is purchase consideration in the above scenario?

Solution

As per paragraph 8 of Ind AS 103, the acquirer shall identify the acquisition date, which is the date on which it obtains control of the aquiree. In the above scenario, the acquisition date will the date on which the shares were allotted to the shareholders of Ram Ltd. Although the shareholder approval was obtained on 10th June, 20X2 but the shares were issued only on 15th June, 20X2. Accordingly, the purchase consideration will be on the basis of ₹ 90 ie. the market price on that date. Hence total purchase consideration would be ₹ 10,80,000 (ie 12,000 shares x ₹ 90).

*****

Illustration 36

The balance sheet of Professional Ltd. and Dynamic Ltd. as of 31st March, 20X2 is given below:

Assets	***Professional Ltd***	***Dynamic Ltd***
Non-Current Assets:		
Property, plant and equipment	300	500
Investment	400	100
Current assets:		
Inventories	250	150
Financial assets		
Trade receivables	450	300
Cash and cash equivalents	200	100
Others	400	230
Total	2,000	1,380

Equity and Liabilities		
Equity		
Share capital- Equity shares of ₹ 100 each	*500*	*400*
Other Equity	*810*	*225*
Non-Current liabilities:		
Long term borrowings	*250*	*200*
Long term provisions	*50*	*70*
Deferred tax	*40*	*35*
Current Liabilities:		
Short term borrowings	*100*	*150*
Trade payables	*250*	*300*
Total	*2,000*	*1,380*

Other information

a. Professional Ltd. acquired 70% shares of Dynamic Ltd. on 1st April, 20X2 by issuing its own shares in the ratio of 1 share of Professional Ltd. for every 2 shares of Dynamic Ltd. The fair value of the shares of Professional Ltd was ₹ 40 per share.

b. The fair value exercise resulted in the following: (all nos in Lakh)

a. Fair value of PPE on 1st April, 20X2 was ₹ 350 lakhs.

b. Professional Ltd also agreed to pay an additional payment as consideration that is higher of 35 lakh and 25% of any excess profits in the first year, after acquisition, over its profits in the preceding 12 months made by Dynamic Ltd. This additional amount will be due after 2 years. Dynamic Ltd has earned ₹ 10 lakh profit in the preceding year and expects to earn another ₹ 20 Lakh.

c. In addition to above, Professional Ltd also had agreed to pay one of the founder shareholder a payment of ₹ 20 lakh provided he stays with the Company for two year after the acquisition.

d. Dynamic Ltd had certain equity settled share based payment award (original award) which got replaced by the new awards issued by Professional Ltd. As per the original term the vesting period was 4 years and as of the acquisition date the employees of Dynamic Ltd have already served 2 years of service. As per the replaced awards the vesting period has been reduced to one year (one year from the acquisition date). The fair value of the award on the acquisition date was as follows:

i. Original award- ₹ 5 lakh

ii. Replacement award-₹ 8 lakh.

e. Dynamic Ltd had a lawsuit pending with a customer who had made a claim of ₹ 50 lakh. Management reliably estimated the fair value of the liability to be ₹ 5 lakh.

f. The applicable tax rate for both entities is 30%.

You are required to prepare opening consolidated balance sheet of Professional Ltd as on 1st April, 20X2. Assume 10% discount rate.

Solution

Consolidated Balance Sheet of Professional Ltd as on 1st April, 20X2 **(₹ in Lakhs)**

	Amount
Assets	
Non-Current Assets:	
Property, plant and equipment	650
Investment	500
Current assets:	
Inventories	400
Financial assets:	
Trade receivables	750
Cash and cash equivalents	300
Others	630
Total	3,230
Equity and Liabilities	
Equity	
Share capital- Equity shares of ₹ 100 each	514
Other Equity	1128.62
NCI	154.95
Non-Current liabilities:	
Long term borrowings	450
Long term provisions (50+70+28.93)	148.93
Deferred tax	28.5
Current Liabilities:	
Short term borrowings	250
Trade payables	550
Provision for Law suit Damages	5
Total	3230

Notes:

a. Fair value adjustment- As per Ind AS 103, the acquirer is required to record the assets and liabilities at their respective fair value. Accordingly, the PPE will be recorded at ₹ 350 lakhs.

b. The value of replacement award is allocated between consideration transferred and post combination expense. The portion attributable to purchase consideration is determined based on the fair value of the replacement award for the service rendered till the date of the acquisition. Accordingly, 2.5 (5 x 2/4) is considered as a part of purchase consideration and is credited to Professional Ltd equity as this will be settled in its own equity. The balance of 2.5 will be recorded as employee expense in the books of Dynamic Ltd over the remaining life, which is 1 year in this scenario.

c. There is a difference between contingent consideration and deferred consideration. In the given case 35 is the minimum payment to be paid after 2 years and accordingly will be considered as deferred consideration. The other element is if company meet certain target then they will get 25% of that or 35 whichever is higher. In the given case since the minimum what is expected to be paid the fair value of the contingent consideration has been considered as zero. The impact of time value on deferred consideration has been given @ 10%.

d. The additional consideration of ₹ 20 lakhs to be paid to the founder shareholder is contingent to him/her continuing in employment and hence this will be considered as employee compensation and will be recorded as post combination expenses in the income statement of Dynamic Ltd.

Working for Purchase consideration **₹ in lakhs**

Particulars		Amount
Share capital of Dynamic Ltd		400
Number of shares	4,00,000	
Shares to be issued 2:1	2,00,000	
Fair value per share		40
PC (2,00,000 x 70% x ₹ 40 per share) (A)		56.00
Deferred consideration after discounting ₹ 35 lakhs for 2 years @ 10% (B)		28.93
Replacement award Market based measure of the acquiree award (5) x ratio of the portion of the vesting period completed (2) / greater of the total vesting period (3) or the original vesting period (4) of the acquiree award ie (5 x 2 / 4) (C)		2.50
PC in lakhs (A+B+C)		87.43

Purchase price allocation workings

Particulars	Book value (A)	Fair value (B)	FV adjustment (A-B)
Property, plant and equipment	500	350	(150)

Investment	100	100	-
Inventories	150	150	-
Financial assets:			-
Trade receivables	300	300	-
Cash and cash equivalents	100	100	-
Others	230	230	
Less: Long term borrowings	(200)	(200)	-
Long term provisions	(70)	(70)	-
Deferred tax	(35)	(35)	-
Short term borrowings	(150)	(150)	-
Trade payables	(300)	(300)	-
Contingent liability	-	(5)	(5)
Net assets (X)	625	470	(155)
Deferred tax Asset on FV adjustment (155 x 30%) (Y)		46.50	155
Net assets (X+Y)		516.5	
Non-controlling interest (516.50 x 30%) rounded off		154.95	
Capital Reserve (Net assets – NCI – PC)		274.12	
Purchase consideration (PC)		87.43	

Consolidation workings

	Professional Ltd	*Dynamic Ltd (pre-acquisition)*	*PPA Allocation*	*Total*
Assets				
Non-Current Assets:				
Property, plant and equipment	300	500	(150)	650
Investment	400	100		500
Current assets:				
Inventories	250	150		400

Financial assets:				
Trade receivables	450	300		750
Cash and cash equivalents	200	100		300
Others	400	230		630
Total	2,000	1,380	(150)	3230
Equity and Liabilities				
Equity				
Share capital- Equity shares of ₹ 100 each	500			
Shares allotted to Dynamic Ltd. (2,00,000 x 70% x ₹ 10 per share)			14	514
Other Equity	810		318.62	1128.62
Non-controlling interest	0		154.95	154.95
Non-Current liabilities:				
Long term borrowings	250	200		450
Long term provisions	50	70	28.93	148.93
Deferred tax	40	35	(46.5)	28.5
Current Liabilities:				
Short term borrowings	100	150		250
Trade payable	250	300	0	550
Liability for lawsuit damages			5	5
Total	2,000	755	475	3230
Other Equity				
Other Equity	810			810
Replacement award			2.5	2.5
Security Premium Reserve (2,00,000 shares x 70% x ₹ 30)			42	42
Capital Reserve			274.12	274.12
	810		318.62	1128.62

17. CARVE OUT IN IND AS 103 FROM IFRS 3

As per IFRS: IFRS 3 requires bargain purchase gain arising on business combination to be recognised in profit or loss as income.

Carve out: Ind AS 103 requires the bargain purchase gain to be recognised in other comprehensive income and accumulated in equity as capital reserve, unless there is no clear evidence for the underlying reason for classification of the business combination as a bargain purchase, in which case, it shall be recognised directly in equity as capital reserve. A similar carve-out is made in Ind AS 28, Investments in Associates and Joint Ventures.

Reasons: At present, since bargain purchase gain occurs at the time of acquiring a business, these are considered as capital reserve. Recognition of such gains in profit or loss would result into recognition of unrealised gains, which may get distributed in the form of dividends. Moreover, such a treatment may lead to structuring through acquisitions, which may not be in the interest of the stakeholders of the company. "

18. CARVE-IN IN IND AS 103 FROM IFRS 3

As per IFRS: IFRS 3 excludes from its scope business combinations of entities under common control.

Carve-in: Appendix C of Ind AS 103, *Business Combinations* gives guidance in this regard.

TEST YOUR KNOWLEDGE

Questions

1. Company A and Company B are in power business. Company A holds 25% of equity shares of Company B. On 1st November, Company A obtains control of Company B when it acquires a further 65% of Company B's shares, thereby resulting in a total holding of 90%. The acquisition had the following features:

   - **Consideration:** Company A transfers cash of ₹ 59,00,000 and issues 1,00,000 shares on 1st November. The market price of Company A's shares on the date of issue is ₹ 10 per share. The equity shares issued as per this transaction will comprise 5% of the post-acquisition equity capital of Company A.
   - **Contingent consideration:** Company A agrees to pay additional consideration of ₹ 7,00,000 if the cumulative profits of Company B exceed ₹ 70,00,000 over the next two years. At the acquisition date, it is not considered probable that the extra consideration will be paid. The fair value of the contingent consideration is determined to be ₹ 3,00,000 at the acquisition date.
   - **Transaction costs:** Company A pays acquisition-related costs of ₹ 1,00,000.
   - **Non-controlling interests (NCI):** The fair value of the NCI is determined to be ₹ 7,50,000 at the acquisition date based on market prices. Company A elects to measure non-controlling interest at fair value for this transaction.
   - **Previously held non-controlling equity interest:** Company A has owned 25% of the shares in Company B for several years. At 1st November, the investment is included in Company A's consolidated balance sheets at ₹ 6,00,000, accounted for using the equity method; the fair value is ₹ 20,00,000.

   The fair value of Company B's net identifiable assets at 1st November is ₹ 60,00,000, determined in accordance with Ind AS 103.

   Determine the accounting under acquisition method for the business combination by Company A.

2. On 30th September, 20X1 Entity A issues 2.5 shares in exchange for each ordinary share of Entity B. All of Entity B's shareholders exchange their shares in Entity B. Therefore, Entity A issues 150 ordinary shares in exchange for all 60 ordinary shares of Entity B.

   The fair value of each ordinary share of Entity B at 30th September, 20X1 is ₹ 40. The quoted market price of Entity A's ordinary shares at that date is ₹ 16.

   The fair values of Entity A's identifiable assets and liabilities at 30th September, 20X1 are the same as their carrying amounts, except that the fair value of Entity A's non- current assets at 30th September, 20X1 is 1,500.

   The statements of financial position of Entity A and Entity B immediately before the business combination are:

	Entity A (legal parent, accounting acquiree)	**Entity B** (legal subsidiary, accounting acquirer)
Current assets	500	700
Non-current assets	1,300	3,000
Total assets	1,800	3,700
Current liabilities	300	600
Non-current liabilities	400	1,100
Total liabilities	700	1,700
Shareholders' equity		
Retained earnings	800	1,400
Issued equity		
100 ordinary shares	300	
60 ordinary shares		600
Total shareholders' equity	1,100	2,000
Total liabilities and shareholders' equity	1,800	3,700

Assume that Entity B's earnings for the annual period ended 31st December, 20X0 were 600 and that the consolidated earnings for the annual period ended 31st December, 20X1 were 800. Assume also that there was no change in the number of ordinary shares issued by Entity B during the annual period ended 31st December, 20X0 and during the period from 1st January, 20X1 to the date of the reverse acquisition on 30th September, 20X1.

Calculate the fair value of the consideration transferred measure goodwill and prepare consolidated balance sheet as on September 30, 20x1. Also compute Earnings per share as on December 30, 20x1.

3. **Scenario 1: New information on the fair value of an acquired loan**

Bank F acquires Bank E in a business combination in October, 20X1. The loan by Bank E to Borrower B is recognised at its provisionally determined fair value. In December 20X1, F receives Borrower B's financial statements for the year ended 30th September, 20X1, which indicate significant decrease in Borrower B's income from operations. Basis this, the fair value of the loan to B at the acquisition date is determined to be less than the amount recognised earlier on a provisional basis.

Scenario 2: Decrease in fair value of acquired loan resulting from an event occurring during the measurement period

Bank F acquires Bank E in a business combination in October, 20X1. The loan by Bank E to Borrower B is recognised at its provisionally determined fair value. In December 20X1, F receives information that Borrower B has lost its major customer earlier that month and this is expected to have a significant negative effect on B's operations.

Comment on the treatment done by Bank F.

4. Company A acquired 90% equity interest in Company B on 1st April, 20X1 for a consideration of ₹ 85 crores in a distress sale. Company B did not have any instrument recognised in equity. The Company appointed a registered valuer with whose assistance, the Company valued the fair value of NCI and the fair value identifiable net assets at ₹ 15 crores and ₹ 100 crores respectively.

   Find the value at which NCI has to be shown in the financial statements

5. On 1st April, 20X1, Company A acquired 5% of the equity share capital of Company B for 1,00,000. A accounts for its investment in B at Fair Value through OCI (FVOCI) under Ind AS 109, *Financial Instruments: Recognition and Measurement*. At 31st March, 20X2, A carried its investment in B at fair value and reported an unrealised gain of ₹ 5,000 in other comprehensive income, which was presented as a separate component of equity. On 1st April, 20X2, A obtains control of B by acquiring the remaining 95 percent of B.

   Comment on the treatment to be done based on the facts given in the question.

6. Company A acquires 70 percent of Company S on 1st January, 20X1 for consideration transferred of ₹ 5 million. Company A intends to recognise the NCI at proportionate share of fair value of identifiable net assets. With the assistance of a suitably qualified valuation professional, A measures the identifiable net assets of B at ₹ 10 million. A performs a review and determines that the business combination did not include any transactions that should be accounted for separately from the business combination.

   State whether the procedures followed by A and the resulting measurements are appropriate or not. Also calculate the bargain purchase gain in the process.

Answers

1. ***Identify the acquirer***

In this case, Company A has paid cash consideration to shareholders of Company B. Further, the shares issued to Company B pursuant to the acquisition do not transfer control of Company A to erstwhile shareholders of Company B. Therefore, Company A is the acquirer and Company B is the acquiree.

Determine acquisition date

As the control over the business of Company B is transferred to Company A on 1st November, that date is considered as the acquisition date.

Determine the purchase consideration

The purchase consideration in this case will comprise the following:

Cash consideration	₹ 59,00,000
Equity shares issued (1,00,000 x 10 i.e., at fair value)	₹ 10,00,000
Contingent consideration (at fair value)	₹ 3,00,000
Fair value of previously held interest	₹ 20,00,000

As such, the total purchase consideration is ₹ 92,00,000.

Acquisition cost incurred by and on behalf of the Company A for acquisition of Company B should be recognised in the Statement of profit and loss. As such, an amount of ₹ 1,00,000 should be recognised in Statement of profit and loss.

Determine fair value of identifiable assets and liabilities

The fair value of identifiable net assets is determined at ₹ 60,00,000.

Measure NCI

The management has decided to recognise the NCI at its fair value. As such, the NCI will be recognised at ₹ 7,50,000.

Re-measure previously held interests in case business combination is achieved in stages

In this case, the control has been acquired in stages i.e., before acquisition to control, the Company A exercised significant influence over Company B. As such, the previously held interest should be measured at fair value and the difference between the fair value and the

carrying amount as at the acquisition date should be recognised in Statement of Profit and Loss. As such, an amount of ₹ 14,00,000 (i.e., 20,00,000 less 6,00,000) will be recognised in Statement of profit and loss.

Assume that Entity B's earnings for the annual period ended 31st December, 20X0 were 600 and that the consolidated earnings for the annual period ended 31st December, 20X1 were 800. Assume also that there was no change in the number of ordinary shares issued by Entity B during the annual period ended 31st December, 20X0 and during the period from 1st January, 20X1 to the date of the reverse acquisition on 30th September, 20X1.

Determination of goodwill or gain on bargain purchase

Goodwill should be calculated as follows: **(₹)**

Total consideration	92,00,000
Recognised amount of any non-controlling interest	7,50,000
Less: fair value of Lila-Domestic's net identifiable assets	(60,00,000)
Goodwill	**39,50,000**

2. **Identifying the acquirer**

As a result of Entity A issuing 150 ordinary shares, Entity B's shareholders own 60 per cent of the issued shares of the combined entity (i.e., 150 of the 250 total issued shares). The remaining 40 per cent are owned by Entity A's shareholders. Thus, the transaction is determined to be a reverse acquisition in which Entity B is identified as the accounting acquirer while Entity A is the legal acquirer.

Calculating the fair value of the consideration transferred

If the business combination had taken the form of Entity B issuing additional ordinary shares to Entity A's shareholders in exchange for their ordinary shares in Entity A, Entity B would have had to issue 40 shares for the ratio of ownership interest in the combined entity to be the same. Entity B's shareholders would then own 60 of the 100 issued shares of Entity B — 60 per cent of the combined entity. As a result, the fair value of the consideration effectively transferred by Entity B and the group's interest in Entity A is 1,600 (40 shares with a fair value per share of 40).

The fair value of the consideration effectively transferred should be based on the most reliable measure. Here, the quoted market price of Entity A's shares provides a more reliable basis for measuring the consideration effectively transferred than the estimated fair value of the shares in Entity B, and the consideration is measured using the market price of Entity A's shares — 100 shares with a fair value per share of 16.

Measuring goodwill

Goodwill is measured as the excess of the fair value of the consideration effectively transferred (the group's interest in Entity A) over the net amount of Entity A's recognised identifiable assets and liabilities, as follows:

Consideration effectively transferred		1,600
Net recognised values of Entity A's identifiable assets and liabilities		
Current assets	500	
Non-current assets	1,500	
Current liabilities	(300)	
Non-current liabilities	(400)	(1,300)
Goodwill		300

Consolidated statement of financial position at 30th September, 20X1

The consolidated statement of financial position immediately after the business combination is:

Current assets [700 + 500]	1,200
Non-current assets [3,000 + 1,500]	4,500
Goodwill	300
Total assets	6,000
Current liabilities [600 + 300]	900

Non-current liabilities [1,100 + 400]	1,500
Total liabilities	2,400
Shareholders' equity	
Issued equity 250 ordinary shares [600 + 1,600]	2,200
Retained earnings	1,400
Total shareholders' equity	3,600
Total liabilities and shareholders' equity	6,000

The amount recognised as issued equity interests in the consolidated financial statements (2,200) is determined by adding the issued equity of the legal subsidiary immediately before the business combination (600) and the fair value of the consideration effectively transferred (1,600). However, the equity structure appearing in the consolidated financial statements (i.e., the number and type of equity interests issued) must reflect the equity structure of the legal parent, including the equity interests issued by the legal parent to effect the combination.

Earnings per share

Earnings per share for the annual period ended 31st December, 20X1 is calculated as follows:

Number of shares deemed to be outstanding for the period from 1st January, 20X1 to the acquisition date (i.e., the number of ordinary shares issued by Entity A (legal parent, accounting acquiree) in the reverse acquisition)	150
Number of shares outstanding from the acquisition date to 31st December, 20X1	250
Weighted average number of ordinary shares outstanding [(150 × 9/12) + (250 × 3/12)]	175
Earnings per share [800/175]	4.57

Restated earnings per share for the annual period ended 31st December, 20X0 is 4.00 [calculated as the earnings of Entity B of 600 divided by the number of ordinary shares Entity A issued in the reverse acquisition (150)].

3. **Scenario 1:** The new information obtained by F subsequent to the acquisition relates to facts and circumstances that existed at the acquisition date. Accordingly, an adjustment (i.e., decrease) to in the provisional amount should be recognised for loan to B with a corresponding increase in goodwill.

Scenario 2: Basis this, the fair value of the loan to B will be less than the amount recognised earlier at the acquisition date. The new information resulting in the change in the estimated fair value of the loan to B does not relate to facts and circumstances that existed at the acquisition date, but rather is due to a new event i.e., the loss of a major customer subsequent to the acquisition date. Therefore, based on the new information, F should determine and recognise an allowance for loss on the loan in accordance with Ind AS 109, *Financial Instruments: Recognition and Measurement*, with a corresponding charge to profit or loss; goodwill is not adjusted.

4. In this case, Company A has the option to measure NCI as follows:
    - Option 1: Measure NCI at fair value i.e., ₹ 15 crores as derived by the valuer;
    - Option 2: Measure NCI as proportion of fair value of identifiable net assets i.e., ₹ 10 crores (100 crores x 10%)
5. At the acquisition date A recognises the gain of ₹ 5,000 in OCI as the gain or loss is not allowed to be recycled to income statement as per the requirement of Ind AS 109. A's investment in B would be at fair value and therefore does not require remeasurement as a result of the business combination. The fair value of the 5 percent investment (1,05,000) plus the fair value of the consideration for the 95 percent newly acquired interest is included in the acquisition accounting.
6. The amount of B's identifiable net assets exceeds the fair value of the consideration transferred plus the fair value of the NCI in B, resulting in an initial indication of a gain on a bargain purchase. Accordingly, A reviews the procedures it used to identify and measure the identifiable net assets acquired, to measure the fair value of both the NCI and the consideration transferred, and to identify transactions that were not part of the business combination.

    Following that review, A concludes that the procedures followed and the resulting measurements were appropriate. (₹)

Identifiable net assets	1,00,00,000
Less: Consideration transferred	(50,00,000)
NCI (10 million x 30%)	(30,00,000)
Gain on bargain purchase	20,00,000

CHAPTER 14

CONSOLIDATED FINANCIAL STATEMENTS

LEARNING OUTCOMES

After studying this chapter, you would be able to:

- Examine the term 'control' and analyse it under different facts and situations.
- Evaluate relationship amongst various entities
- Determine the entity for whom and when to prepare consolidated financial statements
- Distinguish among a consolidated financial statement, a separate financial statement and an individual financial statement
- Understand the purpose and design of an investee
- Comprehend the relevant activities of the investee that significantly affect its returns and direction of relevant activities
- Examine the rights which give an investor power over an investee
- Analyse that whether the investor has exposure or rights to variable returns from an investee
- Co-relate the link between power and returns
- Prepare the consolidated financial statements
- Deal with various situations while accounting for and preparation of consolidated financial statements
- Present the consolidated financial statements as per the format prescribed under the statute
- Define joint control & classify the joint arrangements.
- Prepare the financial statements of the parties to a joint arrangement.
- Apply equity method in the case of associates & joint ventures while preparing the consolidated financial statements
- Comprehend the disclosure requirements prescribed under various Ind AS related to Consolidation.

CHAPTER OVERVIEW

The chapter is divided into 8 units.

a) **Unit 1 'Introduction to Consolidated Financial Statements'** discusses a brief introduction of Group entities and its emergence, purpose of consolidated financial statements and differences from 'Accounting Standards' *vis-à-vis* 'Indian Accounting Standards' and carve out in Ind AS from IFRS.

b) **Unit 2 'Important Definitions'** contains glossary of terms as per Ind AS commonly used in the chapter to provide an easy and direct reference point to important terms such as, associate, consolidated financial statements, control of an investee, equity method, group, investment entity, joint arrangement, joint control, joint operation, joint venture, non – controlling interest, parent, power, protective rights, relevant activities, separate financial statements, separate vehicle, significant influence, structured entity & subsidiary.

c) **Unit 3 'Separate financial statements'**, is based on Ind AS 27, Separate financial statements. It is necessary to distinguish between a consolidated financial statement, a separate financial statement and an individual financial statement.

- **An Individual financial statements** are prepared by an entity that does not have a subsidiary, an associate or a joint venture's interest in a joint venture.
- **Separate financial statements** are statements of an investor where investments in the subsidiary, joint venture and associate are accounted for at cost or in accordance with Ind AS 109, Financial Instruments.
- **Consolidated financial statements** are the financial statements of a group in which the assets, liabilities, equity, income and cash flows of the parent and its subsidiaries are presented as those of a single entity. Financial statements in which equity method is applied for investments in joint ventures and associates and there is no subsidiary are technically called 'Economic Entity Financial Statements'. However, in India, the 'Economic Entity Financial Statements' (EEFS) are also termed as Consolidated Financial Statements.

Unit 3 after discussing the concept, provides guidance on the preparation of separate financial statements. The disclosure requirements of Ind AS 27 are discussed in unit 8.

d) **Unit 4 'Consolidated Financial Statements'** briefly discusses the objective and scope of Ind AS 110, Consolidated Financial Statements.

The consolidation is based on the principle of 'control' that is defined and discussed in detail, later in this unit. The unit discusses the concept of control and how the assessment of control is done to identify whether an investor controls an investee so as to consolidate the investee. The assessment of control has to be done in a systematic manner that involves the following key steps:

- Understand the purpose and design of an investee
- Understand the relevant activities and direction of relevant activities

- What are the rights that give an investor power over an investee?
- Whether the investor has exposure, or rights, to variable returns from an investee?
- Is there a link between power and returns?

The principle of control is also discussed in relation to the definition of subsidiary as per the Companies Act, 2013.

Ind AS introduces a concept of investment entities that receives funds from the investors to provide them the investment management services where funds are invested solely for capital appreciation, investment income or both & measures and evaluates its investment on fair value basis. In certain circumstances, the investment entities need not prepare consolidated financial statements. The unit provides guidance on identification & exception to consolidation requirements for investment entities.

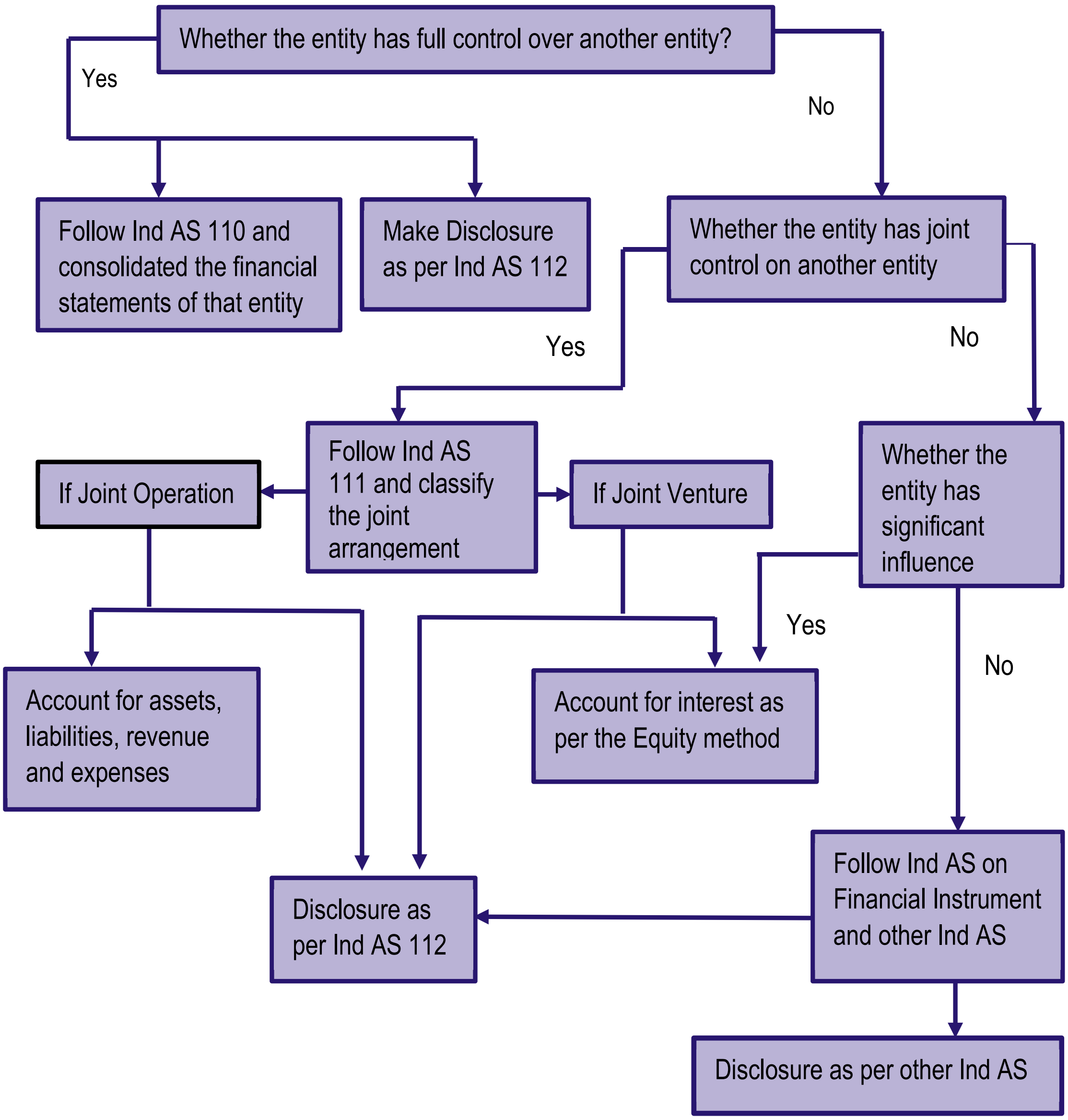
e) **Unit 5 'Consolidated Financial Statements: Accounting of Subsidiaries'** sets out the accounting requirements for the preparation of consolidated financial statements with respect to subsidiaries. It discusses the requirements of consolidation as per the Companies Act, 2013 besides other topic as under:

a. Consolidation procedures
   i. Calculation of good will /capital reserve
   ii. Acquisition of interest in subsidiaries at different dates
b. Uniform accounting policies
c. Measurement
   i. Profit or loss of subsidiary companies
   ii. Potential voting rights
   iii. Dividend received from subsidiary companies
   iv. Preparation of Consolidated Balance Sheet
   v. Elimination of intra – group transactions
   vi. Preparation of Consolidated Statement of Profit and Loss
   vii. Preparation of Consolidated Cash Flow
   viii. Chain holding
   ix. Treatment of subsidiary – preference shares
   x. Inter-company holdings
   xi. Investment in debentures
d. Reporting date
e. Non – controlling interests
f. Loss of control

f) **Unit 6 'Joint Arrangements'** is based on Ind AS 111, Joint Arrangements. It discusses the concept of joint control & defines & classifies the joint arrangements. It also deliberates on the financial statements of the parties to a joint arrangement.

g) **Unit 7 'Investment in Associates & Joint Ventures'** is based on Ind AS 28, Investment in Associates & Joint Ventures and provides guidance on equity method with accounting requirements in the case of associates & joint ventures.

h) **Unit 8 'Disclosures'** is based on the disclosure requirements in separate financial statements as per Ind AS 27, Separate Financial Statements and in consolidated financial statements as per Ind AS 112, Disclosure of Interest in Other entities.



UNIT 1 : INTRODUCTION TO CONSOLIDATED FINANCIAL STATEMENTS

1.1 INTRODUCTION

A business is defined as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower cost or other economic benefits directly to investors or other owners, members or participants. Moreover, one of the key objectives of the business is to grow. This growth can be organic or inorganic. Thus in the market place, entities get restructured, merged, demerged, acquired, disposed of etc., to meet the objectives of various stakeholders.

A business combination is a transaction or other events in which an acquirer obtains control of one or more business. The acquiree may get completely merged with the acquirer and may lose its separate identity or it maintains its separate identity but is closely or otherwise associated with the acquirer. Where the acquiree maintains a separate legal entity, depending upon the terms of association the nature of relationship between the acquirer and acquiree is defined.

If there is a total control on operating and financial policies by the acquirer, the acquiree is termed as a subsidiary and acquirer as a parent. If there is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement, it is known as joint venture and a party that has joint control of that joint venture is known as joint venturer. Where the acquirer has significance influence but no control over these policies, the acquiree is an associate and acquirer is an investor.

Depending upon the relationship identified, the types of financial statements required to be prepared and accounting treatment to be followed for preparation of such financial statements are determined. The parent is required to present consolidated financial statements. The parent may also prepare separate financial statements. Further, exemptions from preparing consolidated financial statements are given in paragraph 4A of Ind AS 110. A venturer or an investor in an associate may in addition present separate financial statements.

The above terms at times confuse the preparers and other users of financial statements. Thus, it is essential to understand the meanings of these terms.

Consolidated financial statements are financial statements of a group rather than an entity.

A **group** in very simple terms, comprises of a parent and its subsidiaries. Each of these entities are linked to each other with a common thread. Under Accounting Standard (AS), the common thread was predominantly static & through operation of law and was pretty straightforward (such as voting rights or composition of the Board of Directors). Under Ind AS, this common thread is more dynamic & through judgment that hinges on 'control'.

A group typically consists of

- a holding company,
- subsidiaries,

Besides, holding companies, subsidiaries, joint ventures and associates, we now also have structured entities, investment entities, special vehicles etc. To define these relationships, the concept of corporate veil is no longer valid. The relationship is examined from the design stage, from the initial drawing board of the board of directors.

Hitherto, determination of a subsidiary was straightforward through an analysis of majority of voting power or composition of board of directors. Now, even with 40% holding, an entity may be a parent of another entity in one set of circumstances. The same 40% holding in another set of circumstances, the relationship may be that of an investor and an associate and the facts may change after a period. Thus, a comprehensive, rigorous & continuous assessment of the relationship is the need of the hour at each reporting date.

1.2 PURPOSE

The business has become complex, the structures have become complex, the business transactions have become complex and this complex situation has become all the more complex with information overload. An investor gets lost if he intends to understand a group from a financial perspective. Consolidated financial statements paves the way to a large extent for a stakeholder to achieve the desired objective.

Ind AS defines the various terms be it group, subsidiary, associate, et al, when & how the relationship has to be deciphered, what accounting procedures have to be performed to prepare and present consolidated financial statements. The objective is to bring, as is true with any accounting standard, a very high level of standardization through interpretation & disclosures with minimal exceptions.

1.3 FROM AS TO IND AS

1. Under the Companies (Accounting Standards) Rules 2006, the following accounting standards provided guidance on preparation of consolidated financial statements:
   a. Accounting Standard (AS) 21: Consolidated Financial Statements
   b. Accounting Standard (AS) 23: Accounting for Investments in Associates in Consolidated Financial Statements
   c. Accounting Standard (AS) 27: Financial Reporting of Interests in Joint Ventures
2. Under Ind AS, the guidance is much more detailed. As per the Companies (Indian Accounting Standards) Rules 2015, the following accounting standards provides guidance on preparation of consolidated financial statements:
   a. Indian Accounting Standard (Ind AS) 110: Consolidated Financial Statements

b. Indian Accounting Standard (Ind AS) 111: Joint Arrangements

c. Indian Accounting Standard (Ind AS) 112: Disclosure of Interests in Other Entities

d. Indian Accounting Standard (Ind AS) 28: Investments in Associates and Joint Ventures

3. The focus in Ind AS is on substance over form. It is the de-facto evaluation rather than the de-jure evaluation that determines the relationship of subsidiary, joint arrangement or associate.

4. The objective of Ind AS 110, Consolidated Financial Statements, is to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more entities.

5. The objective of Ind AS 111, Joint Arrangements, is to establish principles for financial reporting by entities that have an interest in arrangements that are controlled jointly (Joint arrangements).

6. The objective of Ind AS 112, Disclosure of Interests in Other Entities, is to require an entity to disclose information that enables users of its financial statements to evaluate.

7. The objective of Ind AS 27, Separate Financial Statements, is to prescribe the accounting and disclosure requirements for investments in subsidiaries, joint ventures and associates when an entity prepares separate financial statements.

8. The objective of Ind AS 28, Investments in Associates & Joint Ventures, is to prescribe the accounting for investments in associates and to set out the requirements for the application of the equity method when accounting for investments in associates & joint ventures.

1.4 SIGNIFICANT DIFFERENCES IN IND AS VIS-À-VIS AS

There are significant differences between Ind AS & AS. The major ones are tabulated as under:

1.4.1 Ind AS 27 on 'Separate Financial Statements' vs AS

S. No.	Topic	Ind AS	AS
		Ind AS 27- Separate Financial Statements (SFS)	**No equivalent standard**
1	Scope	Does not mandate to follow Ind AS 27	
2	Preparation of separate financial statements	Should be prepared in accordance with all applicable Ind AS. Account for investment in subsidiaries, JV, Associates either at cost or as per Ind AS 109 'Financial Instruments'.	

		If classified as held for sale, should be accounted for as per Ind AS 105 'Non-current Assets Held for Sale and Discontinued Operations'.	
3	Treatment of dividend received from a subsidiary, a joint venture or an associate	Recognize in the Statement of Profit and Loss (SPL) when the right to receive dividend is established.	
4	Disclosure Requirements	If an entity does not prepare CFS and prepares only SFS, it shall disclose: the facts of doing so, exemption used, list of investments, method used to account them, etc.	

1.4.2 Ind AS 110 on 'Consolidated Financial Statements' vs AS 21 on 'Consolidated Financial Statements'

S. No.	Topic	Ind AS	AS
		Ind AS 110 'Consolidated Financial Statements'	**AS 21 'Consolidated Financial Statements'**
1	Control	**Principle based:** Investor controls investee when it is exposed or has rights to variable returns from involvement with investee and has ability to affect those returns through its power over investee.	**Rule based:** • Ownership of more than half voting power. • Control of composition of board.
2	Potential Voting Rights	Needs to be considered for control assessment.	Are not considered for control assessment.
3	Uniform Accounting Policies	To be followed and no recognition of situation of impracticability.	If not practicable, facts to be disclosed with brief description.
4	Notes to consolidated financial statements	Such clarifications are not required in Ind AS as Ind AS considers CFS as primary and SFS as secondary whereas under AS, SFS is primary and CFS is secondary.	• All notes appearing in SFS of parent and its subsidiaries need not be included in the notes to CFS. • Notes necessary for true & fair view and notes

S. No.	Topic	Ind AS	AS
			involving material items should be disclosed. • Additional statutory information disclosed in SFS of subsidiaries or parent having no bearing on true & fair view of CFS need not be disclosed.
5	Exclusion of subsidiary from consolidation	All subsidiaries are consolidated.	If subsidiary acquired with intention to dispose of within 12 months or it operates under severe long term restrictions which impair its ability to transfer funds to parent, then subsidiaries need not be consolidated.
6	Treatment in case of more than one parent of a subsidiary	Two investors control an investee when they must act together to direct the activities. Each investor would account for its interest in the investee in accordance with relevant Ind AS. Such as Ind AS 111, 28, 109.	When an entity is controlled by two enterprises as per the definition of control, it will be considered as subsidiary of both controlling enterprises, therefore both need to consolidate the financial statement of that entity as per AS 21.
7	Reporting Dates	The difference in reporting dates should not be more than 3 months	The difference in reporting dates should not be more than 6 months
8	Presentation of minority interest	Should present within equity, separately from the equity of the owners of the parent	Presented separately from liabilities and equity of the parent's shareholder.
9	Allocation of losses to minority interest	Losses should be attributed to owners of parent & to non-controlling interest separately even if it results in deficit of non-controlling interest.	Excess of loss applicable to minority over the minority interest in the equity of subsidiary and any further losses applicable to minority are adjusted against majority interest except to the extent

S. No.	Topic	Ind AS	AS
		This is because Ind AS 110 is based on entity concept whereas AS 21 is based on proprietary concept.	minority has a binding obligation to, and is able to, make good the losses.
10	Disposals	Change in the parent's ownership interest in a subsidiary without the loss of control are accounted for as equity transaction. If parent loses control over subsidiaries, it shall be accounted as: • Derecognize asset & liabilities. • Recognize any investment retained in the former subsidiary at its fair value (Ind AS 109) • Recognize the gain or loss associated with loss of control.	No specific guidance Any loss on control shall be accounted for in Consolidated statement of profit & loss.
11	Structures entities	Defined under Ind AS.	No specific guidance

1.4.3 Ind AS 28 on 'Investments in Associates and Joint Ventures' vs AS 23 on 'Accounting for Investment in Associates in Consolidated Financial Statements'

S. No.	Topic	Ind AS	AS
		Ind AS 28 'Investments in Associates and Joint Ventures'	**AS 23 'Accounting for Investments in Associates in Consolidated Financial Statements'**
1	Significant Influence	Power to participate in financial and operating policy decisions but not control or joint control over those policies.	Power to participate in financial and / or operating policy decisions but not control over those policies.
2	Potential Voting Rights	Are considered for determining significant influence.	Are not considered for determining significant influence.

S. No.	Topic	Ind AS	AS
3	Exception to equity method	Investment entities are exempted from equity method if they measure all investments at FVPL.	Exceptions to equity method are available
4	Option where a part of the investment in associate is held indirectly through certain specific modes	The part so held could be measured at fair value. Equity method to be applied to the remaining portion.	No such exemption
5	Share of losses in entity	Carrying amount of investment with long term interests shall be considered. Discontinue when such carrying amount becomes Nil.	Only carrying amount of interests shall be considered.
6	Loss of significant influence over an associate	A loss of significant influence results in cessation of equity method. If any gain/ loss is resulted, the same is accounted for in profit or loss. The share of loss of associate recognised in OCI is reclassified to profit / loss if such reclassification is required by other standards	No specific guidance
7	Capital reserve/ negative goodwill	Should be recognized directly in equity, on any acquisition	Should be included in carrying amount of associate but disclosed separately.
8	Uniform accounting policies	To be followed unless it is impracticable to do so.	If not practicable, facts to be disclosed with brief description.
9	Reporting date	The difference in reporting dates should not be more than 3 months	No specific guidance
10	Impairment	Objective evidence.	Recognize any decline other than temporary.

1.4.4 Ind AS 111 on 'Joint Arrangements' vs. AS 27 on 'Financial Reporting of Interests in Joint Ventures'

S. No.	Topic	Ind AS	AS
		Ind AS 111- Joint Arrangements	**AS 27- Financial Reporting of Interests in Joint Ventures**
1	Defined Terms	Joint control Joint arrangement Joint operation Joint venture	Joint control Joint venture
2	Accounting Method	Can either be joint operation or joint venture, the classification depends on rights and obligations of parties to arrangement.	Prescribes 3 forms of joint venture: Jointly controlled operations Jointly controlled assets Jointly controlled entities
3	Accounting of interest in jointly controlled entity in the separate financial statements	Accounted for either at cost or as per Ind AS 109. If classified as held for sale, should be accounted for as per Ind AS 105. Equity method should be applied if venturer does not prepare separate financial statements.	As per AS 13 at cost less provision for other than temporary decline.
4	Explanation on the term 'near future'	It is deleted because it is covered under Ind AS 105.	Explanation given in AS 27.
5	Disclosure of venturer's share in post-acquisition reserves of a jointly controlled entity	No specific guidance	Shown separately under the relevant reserve while applying proportionate consolidation method.
6	Accounting in case of joint control over an entity which is a subsidiary of the entity	No recognition of such cases	In exceptional cases, when an enterprise over a contractual arrangement establishes joint control over subsidiary of that enterprise, it is consolidated under AS 21.

1.5 CARVE OUT IN IND AS 28 FROM IAS 28

Ind AS 28, Investment in Associates and Joint Ventures

As per IFRS

IAS 28 requires that for the purpose of applying equity method of accounting in the preparation of investor's financial statements, uniform accounting policies should be used. In other words, if the associate's accounting policies are different from those of the investor, the investor should change the financial statements of the associate by using same accounting policies.

Carve out

In Ind AS 28, the phrase, 'unless impracticable to do so' has been added in the relevant requirements, i.e., paragraph 35.

Reasons

Certain associates, e.g., regional rural banks (RRBs), being associates of nationalized banks, are not in a position to use the Ind AS as these may be too advanced for the RRBs. Accordingly, the above -stated words have been included to exempt such associates.

UNIT 2 : IMPORTANT DEFINITIONS

Following are the key definitions, as per Ind AS, commonly used in the chapter. These definitions will help to understand the chapter and will provide an easy and direct reference to the concepts discussed hereafter.

1. Associate

An associate is an entity over which the investor has significant influence.

2. Consolidated financial statements

Consolidated financial statements are the financial statements of a group in which assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

3. Control of an investee

An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

4. Equity method

The equity method is a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income.

5. Group

A parent and its subsidiaries.

6. Investment entity

An entity that:

(a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;

(b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and

(c) measures and evaluates the performance of substantially all of its investments on a fair value basis.

7. Joint arrangement

A joint arrangement is an arrangement of which two or more parties have joint control.

8. Joint control

Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

9. Joint operation

A joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.

10. Joint venture

A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

11. Joint venturer

A joint venturer is a party to a joint venture that has joint control of that joint venture.

12. Non–controlling interest

Equity in a subsidiary not attributable, directly or indirectly, to a parent.

13. Parent

An entity that controls one or more entities.

14. Power

Existing rights that give the current ability to direct the relevant activities.

Examples of indicators relating to practical ability to direct the investee:

- Non- contractual ability to appoint investees KMP
- Non- contractual ability to direct investee to enter into significant transactions or veto such transactions.
- Ability to dominate the nomination of members to investees governing body.
- Investees KMP or majority of governing body are related parties to investor (for example investee and investor share the same CEO)

15. Substantive rights

Substantive rights are those rights that an investor holds that gives it current ability to direct the investee's relevant activities. In order for a right to be substantive, the holder must have the practical ability to exercise the right.

Examples of substantive rights:

Voting rights held by the majority shareholder giving it the current ability to unilaterally direct relevant activities.

16. Protective rights

Rights designed to protect the interest of the party holding those rights without giving that party power over the entity to which those rights relate.

An investor that only holds protective rights, which meet this definition, has no power over an investee and consequently does not control the investee.

Examples of protective rights are:

- A lender's right to restrict borrower's activities (if these could change credit risk significantly to the detriment of the lender)
- Capital expenditure greater than that required in the ordinary course of business requiring approval by non-controlling interest holders
- Issue of debt or equity instruments requiring approval by non-controlling interest holders
- A lender's right to seize assets of a borrower in the event of default.

17. Relevant activities

For the purpose of this Ind AS, relevant activities are activities of the investee that significantly affect the investee's returns.

18. Separate financial statements

Separate financial statements are those presented by a parent (i.e an investor with control of a subsidiary) or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with Ind AS 109, Financial Instruments.

19. Separate vehicle

A separately identifiable financial structure, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality.

20. Significant influence

Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.

21. Structured entity

An entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

22. Subsidiary

An entity that is controlled by another entity.

UNIT 3: SEPARATE FINANCIAL STATEMENTS

3.1 INTRODUCTION

1. It is necessary to distinguish between a consolidated financial statements, a separate financial statements and an Individual financial statements.

a. An individual financial statement is prepared by an entity that does not have a subsidiary, an associate or a joint venture's interest in a joint venture.

b. Separate financial statements are statements of an investor where investments in the subsidiary, joint venture and associate are accounted for at cost or in accordance with Ind AS 109, Financial Instruments.

c. Consolidated financial statements are the financial statements of a group in which the assets, liabilities, equity, income and cash flows of the parent and its subsidiaries are presented as those of a single entity.

Note: Financial statements in which equity method is applied for investments in joint ventures and associates, technically referred to as economic entity financial statements, are also termed as consolidated financial statements.

2. Separate financial statements are presented in addition to:

a. Consolidated Financial Statements (prepared in case of a subsidiary or subsidiaries); or

b. Financial Statements in which investments in associates and joint ventures are accounted for using equity method.

Note: These financial statements are not separate financial statements.

3. Entity may present separate financial statements as its only financial statements if it is:

a. Exempt from consolidation; or

b. Exempt from applying equity method; or

c. An investment entity and apply exception to consolidation for all of its subsidiaries.

Example:

Entity A Limited has a subsidiary, a joint venture and an associate. It is required to prepare consolidated financial statements. In the consolidated financial statements, it will consolidate:

- The subsidiary as per full consolidation method.
- The associate as per equity method.
- Joint ventures are consolidated as per equity method in CFS whereas joint operations are consolidated as per proportionate consolidation method in IFS

3.2 PREPARATION OF SEPARATE FINANCIAL STATEMENTS

1. Separate financial statements shall be prepared in accordance with all applicable Ind AS, except that it shall account for investments in subsidiaries, joint ventures and associates either:
   a. At cost: Account for in accordance with Ind AS 105, 'Non-current Assets Held for Sale and Discontinued Operations' (if investment is classified as held for sale then cost will be accounted for as per Ind AS; or
   b. In accordance with Ind AS 109 'Financial Instruments'.
2. The entity shall apply the same accounting for each category of investments.

   For example, an entity that has investments in subsidiaries, associates & joint ventures can account for its investments in subsidiaries & associates at cost and investments in joint ventures in accordance with Ind AS 109. However, if that entity has investments in two associates, it cannot account investment in one associate as cost & investment in other associate in accordance with Ind AS 109. It has to choose either of the method for both the investments in associates.
3. An entity may be required to classify its investments in subsidiaries, joint ventures and associates as held for sale (or included in a disposal group that is classified as held for sale) in accordance with Ind AS 105. In such a situation, when these investments are accounted for at cost, they will henceforth be accounted for and measured as per Ind AS 105. However, the measurement of investments accounted as per Ind AS 109, is not changed in such circumstances.
4. **Exceptions:**
   a. Investments in associates and joint ventures could also be held by a venture capital organization, mutual fund, unit trust, investment linked insurance funds or similar entities. In accordance with paragraph 18 of Ind AS 28 'Investments in Associates and Joint Ventures', these entities may elect to measure investments in associates and joint ventures at fair value through profit or loss in accordance with Ind AS 109 in its consolidated financial statements. In these circumstances, the entity shall also measure those investments in associates or joint ventures at fair value through profit or loss in accordance with Ind AS 109 in its separate financial statements also.
   b. An investment entity is not required to consolidate its subsidiaries or apply Ind AS 103, Business Combinations, when it obtains control of another entity. Instead it measures its investment in subsidiaries at fair value through profit or loss in accordance with Ind AS 109 in its consolidated financial statements. It is required to account for its investment in that 'unconsolidated' subsidiary in its separate financial statements also at fair value through profit or loss in accordance with Ind AS 109. It should be noted that an investment entity is required to consolidate a subsidiary or apply Ind AS 103 when that subsidiary provides services that relates to the investment activities of the investment entity. In such a situation, the aforesaid requirement does not apply.

5. Measurement where change of status in case of Investment entities:

a. When an entity ceases to be an investment entity it shall measure its investment in subsidiary either

(i) at cost (fair value of subsidiary at date of status shall be considered as deemed cost); or

(ii) continue to account for as per Ind AS 109

b. When an entity becomes an investment entity:

(i) it shall account for investment in subsidiary at Fair value through profit & loss as per Ind AS 109;

(ii) the difference between the carrying value and fair value shall be recognized in profit or loss;

(iii) any previous fair value adjustments in Other Comprehensive Income (OCI) shall be treated as if investment entity had disposed off those subsidiary at the date of change in status.

6. Recognition of dividend:

Dividend shall be recognized when its right to receive is established.

7. Measurement where parent reorganized the group:

a. A parent may reorganize the structure of its group by establishing a new entity as its parent in a manner that satisfies the following criteria:

(i) New parent obtains control by issuing equity instruments in exchange of existing equity instruments.

(ii) Assets & liabilities of new & original group are same immediately before and after reorganization.

(iii) Owners have same absolute & relative interest in net assets of original group and the new group, immediately before and after reorganization

(iv) The new parent accounts for its investment in the original parent in its separate financial statements,

b. In these circumstances, the new parent shall measure cost at the carrying amount of its share of the equity items shown in the separate financial statements of the original parent at the date of the reorganization.

c. Similarly, an entity that is not a parent might establish a new entity as its parent in a manner that satisfies the criteria above. The above requirements apply equally to such reorganizations.

UNIT 4: CONSOLIDATED FINANCIAL STATEMENTS

4.1 OBJECTIVE

The objective of Ind AS 110 'Consolidated Financial Statements' is to establish principles for the presentation and preparation of consolidated financial statements when an entity (the parent) controls one or more other entities (subsidiaries).

4.2 SCOPE

A parent who controls one or more entities is required to present consolidated financial statements.

However, a parent is not required to present consolidated financial statements if it meets all of the following four conditions.

Condition 1:	The parent is either a wholly owned subsidiary or a partially owned subsidiary of another entity. Further its other owners (including those not entitled to vote) have been informed and do not object, to the parent not presenting the consolidated financial statements.
Condition 2:	The equity instruments or the debt instruments of the parent are not traded in a public market. The public market could be a domestic or foreign stock exchange or an over the counter market including local and regional markets.
Condition 3:	The parent has neither filed nor is in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market.
Condition 4:	The ultimate or any intermediate parent, of the parent (that is required to present consolidated financial statements), produces financial statements that are available for public use and comply with Ind AS, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with Ind AS 110.

Further, a parent who fulfils the following two conditions is also not required to present consolidated financial statements:

Condition 1:	The parent is an investment entity
Condition 2:	The parent is required to measure all its subsidiaries at fair value through statement of profit or loss.

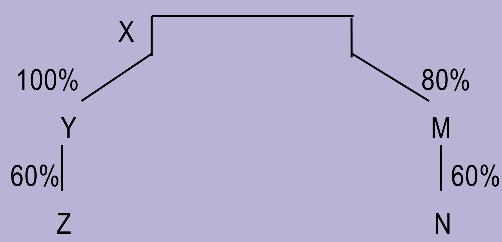
Also, Ind AS 110 does not apply to post – employment benefit plans or other long term employee benefit plans to which Ind AS 19 'Employee Benefits', applies.

Example: Exemption from preparing consolidated financial statements.

Entity X owns the following other entities:

1. 100% interest in entity Y. Entity Y owns 60% interest in entity Z.
2. 80% interest in entity M. Entity M owns 60% interest in entity N.

The structure is illustrated as follows:



Entity X is a listed company and prepares IND AS compliant consolidated financial statements. Entities Y & M do not have their securities publically traded & they are not in the process of issuing securities in public markets. Entity X does not require its subsidiary M to prepare consolidated financial statements. Entity Y is a wholly- owned subsidiary of entity X. Entity Y is not required to prepare consolidated financial statements.

Entity M is not required to prepare consolidated financial statements provided, the non-controlling interest holders have been informed about, and do not object to Entity M presenting consolidated financial statements.

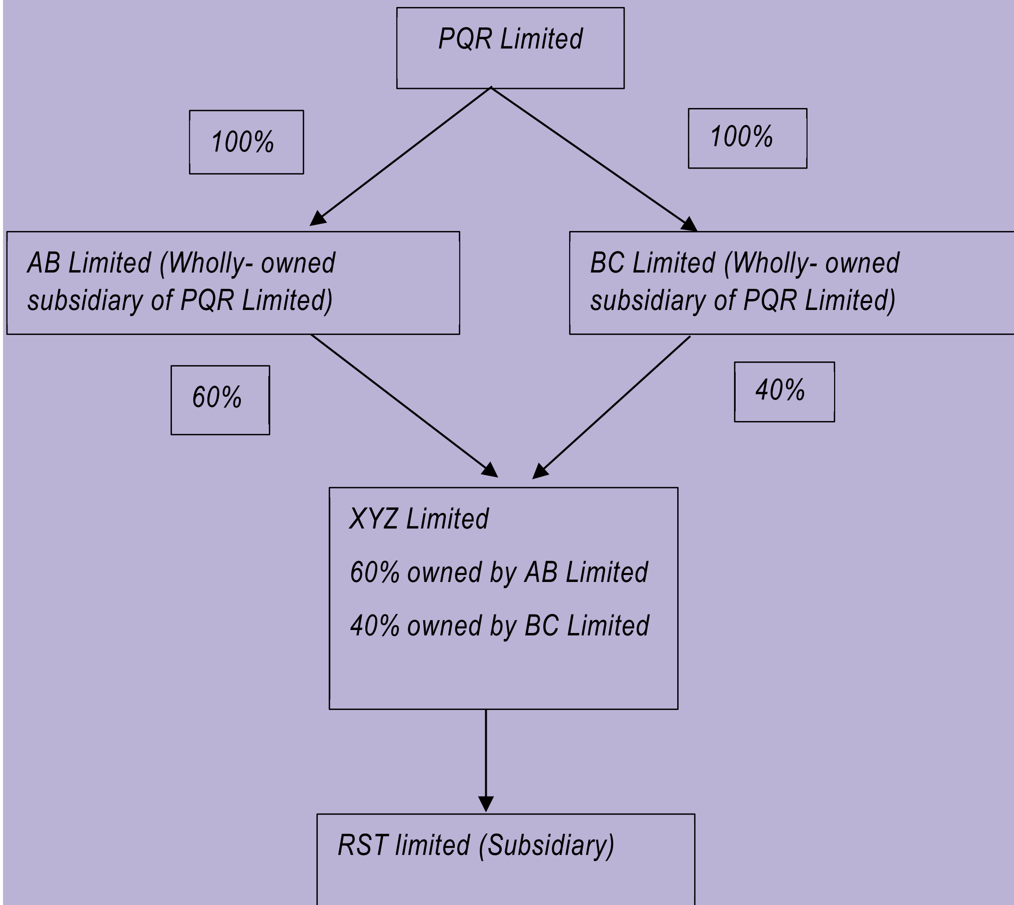
Example: Where local regulations govern the participation of consolidated financial statements.

At times local regulations dictate when, and for what periods, an entity must present consolidated or separate financial statements. Local regulations might allow or require an intermediate parent to produce separate financial statements prepared in accordance with Ind AS, instead of consolidated financial statements.

Where local regulations permit an entity not to prepare consolidated financial statements, the entity should still consider the exemptions as per Ind AS 110 and determine whether it is exempt from preparing consolidated financial statements.

Illustration 1

Following is the structure of a group headed by PQR Limited



Whether XYZ Limited can avail the exemption from the preparation and presentation of consolidated financial statements? What if the facts are the same as above except that, AB Limited and BC Limited are both owned by an Individual (Mr. X) instead of PQR Limited?

Under both the scenarios, XYZ Limited wishes to avail the exemption provided in Ind AS 110 from the presentation of consolidated financial statements. Assuming other conditions for such exemption are fulfilled, whether XYZ Limited is required to inform its other owner BC Limited (owning 40%) of its intention to not prepare consolidated financial statements?

Solution

As per paragraph 4(a)(i) of Ind AS 110, a parent need not present consolidated financial statements if it is a:

- wholly-owned subsidiary; or

- is a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements.

In Scenario I, although XYZ Limited is a partly-owned subsidiary of AB Limited, it is the wholly-owned subsidiary of PQR Limited and therefore satisfies the condition 4(a)(i) of Ind AS 110 without regard to the relationship with its immediate owners, i.e. AB Limited and BC Limited. Thus, XYZ Limited being the wholly owned subsidiary is not required to inform its other owner BC Limited of its intention not to prepare the consolidated financial statements.

Therefore, XYZ Limited may take the exemption given under Ind AS 110 from presentation of consolidated financial statements.

In Scenario II, XYZ Limited is ultimately wholly in control of Mr. X (i.e., an individual) and hence it cannot be considered as a wholly owned subsidiary of an entity.

This is because Ind AS 110 makes use of the term ‘entity’ and the word 'entity’ includes a company as well as any other form of entity. Since, Mr. X is an ‘individual’ and not an ‘entity’, therefore, XYZ Limited cannot be considered as wholly owned subsidiary of an entity.

Therefore, in the given case, XYZ Limited is a partially-owned subsidiary of another entity. Accordingly, in order to avail the exemption, its other owner, BC Limited should be informed about and do not object to XYZ Limited not presenting consolidated financial statements. Further, for the purpose of consolidation of AB Limited and BC Limited, XYZ Limited will be required to provide relevant financial information as per Ind AS.

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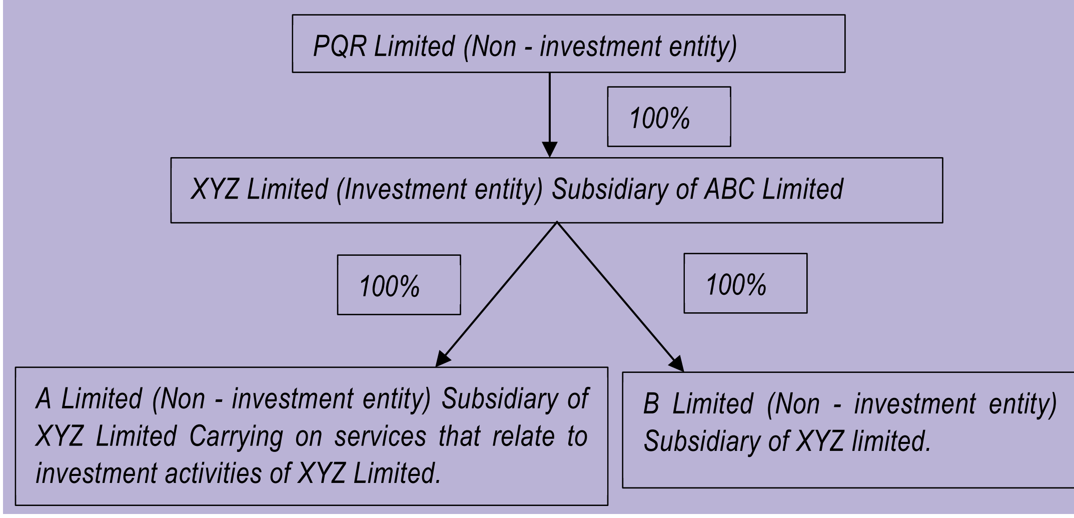
Illustration 2

Following is the structure of a group headed by PQR Limited:



State whether PQR Limited and XYZ Limited are required from their respective reporting standpoint to present consolidated financial statements? Assume that the other conditions mentioned under paragraph 4(a)(i) to 4(a)(iii) related to such exceptions are satisfied for above entities.

Solution

As per paragraph 4(a) of Ind AS 110, a parent need not present consolidated financial statements if it meets all the conditions specified therein. One of the condition as mentioned under paragraph 4(a)(iv) for the exemption from the presentation of consolidated financial statements is if ultimate or any intermediate parent of the parent entity produces financial statements that are available for public use and comply with Ind AS, in which subsidiaries are consolidated or are measured at fair value through profit or loss (FVTPL) in accordance with Ind AS 110.

Further, paragraph 4B of Ind AS 110 specifically provides that an investment entity shall not present consolidated financial statements if it is required by the Standard to measure all of its subsidiaries at FVTPL as provided in paragraph 31 of Ind AS 110.

Paragraphs 31 and 32 of Ind AS 110 provide that an investment entity shall measure an investment in a subsidiary at FVTPL in accordance with Ind AS 109. However, if the subsidiary is not itself an investment entity and whose main purpose and activities are providing services that relate to the investment entity's investment activities, then the investment entity shall consolidate that subsidiary.

Paragraph 33 further provides that, a parent of an investment entity shall consolidate all entities that it controls, including those controlled through an investment entity subsidiary, unless the parent itself is an investment entity.

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Accordingly, in the present case, the following position regarding preparation of consolidated financial statements emerges:

From the perspective of PQR Limited

There are no exemptions under paragraph 4 from the presentation of consolidated financial statements to a non-investment entity which is the ultimate parent entity in the group. Further, paragraph 33 of Ind AS 110 provides that a parent of an investment entity shall consolidate all entities that it controls, including those controlled through an investment entity subsidiary, unless the parent itself is an investment entity.

Accordingly, PQR Limited is required to present its consolidated financial statements.

From the perspective of XYZ Limited

It is an investment entity and has two subsidiaries, A Limited and B Limited. Subsidiary A Limited is a non-investment entity which provides the services that relate to the investment activities undertaken by XYZ Limited.

XYZ Limited is required to:

(i) consolidate A Limited [combining the like items of assets, liabilities and equity etc.]; and

(ii) measure investments in B Limited at FVTPL.

Since the ultimate parent company of XYZ Limited i.e., PQR Limited presents consolidated financial statements under Ind AS, XYZ Limited is eligible for exemption from the presentation of consolidated financial statements as its ultimate parent entity, i.e., PQR Limited produces financial statements that are available for public use and comply with Ind AS, in which subsidiaries are consolidated or are measured at fair value through profit or loss (FVTPL) as appropriate, in accordance with Ind AS 110.

However, for the purpose of internal reporting to parent entity, XYZ Limited will be required to provide financial information data prepared as per Ind AS.

4.3 CONCEPT OF CONTROL

a. As per Ind AS 110, consolidation of an investee shall begin from the date the investor (parent) obtains control of the investee (subsidiary);

   Analysis

   Thus:

   (i) Parent (Investor) is an entity that controls one or more entities;

   (ii) Subsidiary (Investee) is an entity that is controlled by another entity;

b. An investor controls an investee if and only if the investor has all the following 3 elements:

   (i) Power over the investee;

   (ii) Exposure, or rights, to variable returns from its involvement with the investee; and

   (iii) The ability to use its power over the investee to affect the amount of the investor's returns.

   An investor shall consider all facts and circumstances to assess whether it controls an investee. It should re-assess the control when facts and circumstances suggest that there is a change in any of the aforesaid 3 elements.

   There could be situations where no single investor controls an investee. In these types of situation, the interest and relationship of the investor with the investee would be determined in accordance with:

   - Ind AS 111, Joint Arrangements;
   - Ind AS 28, Investments in Associates and Joint Ventures; or
   - Ind AS 109, Financial Instrument.

c. The definition of control is in 3 limbs or elements, all of which should co - exist:

   (i) Power over the investee;

(ii) Exposure to variable returns;

(iii) Ability to use power to impact returns.

d. Power over the investee

(i) An investor has power over an investee when the investor:

- has existing rights
- that give it the current ability
- to direct relevant activities (activities that significantly affect the investee's returns).

(ii) In simple situations, control can be demonstrated through voting rights. If an entity controls over 50% of voting rights, entity controls the investee;

(iii) However, in complex situations, voting rights may not be the sole indicator. As required by Ind AS, the principle of substance over form shall prevail.

e. Exposure to variable returns:

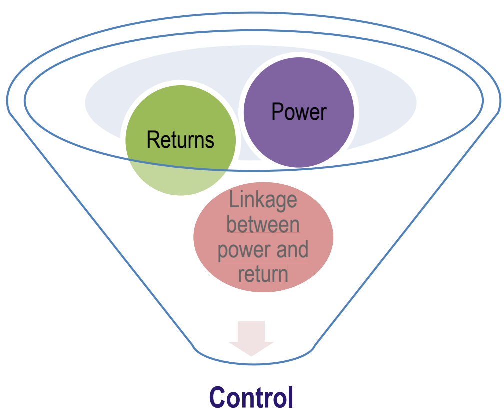
(i) An investor is exposed, or has rights, to variable returns from its involvement with the investee when the investor's returns from its involvement can vary because of investee's performance. The returns can be only positive, only negative or both positive and negative.

(ii) Even though only one investor can control the investee, more than one party can share the returns of an investee, such as holders of non – controlling interests.

f. Link between power and returns:

(i) An investor should, in addition to power and exposure to variable returns, have the ability to use the power to affect its return from the investee for determining control.

(ii) There could be a situation when a person (agent) may have the decision making rights in an investee and its remuneration is also based on the performance of the investee but it may be acting on behalf of another person (principal). In this situation, the agent does not control an investee.



g. The following seven steps should be adopted to assess control. Steps 1 to 5 assist in establishing whether an investor has power over the investee. Step 6 discusses the exposure to variable returns whereas step 7 deliberates on link between power & returns.

Step 1: What is the purpose of the investee?

Step 2: What is the design of the investee?

Step 3: What are the relevant activities of the investee that significantly affect its returns?

Step 4: How decisions about the relevant activities are made?

Step 5: Whether the decision maker is empowered and has the right to take those decisions?

Step 6: The investor should examine whether it is exposed to or have variable returns from its involvement with the investee.

Variable returns are returns that are not fixed and have the potential to vary as a result of the performance of an investee. Variable returns can be only positive, only negative or both positive and negative.

Step 7: Link between power & variable returns.

This step needs examination whether the investor can use its power to impact the variable returns. If so, this condition is also satisfied.

We will now discuss each of these steps in detail.

4.4 ASSESSMENT OF CONTROL

4.4.1 Step 1: Purpose of the investee

It should be determined that why the investee has been formed or incorporated? What is the purpose and objective of the investee? Whether it has been incorporated to implement a vertical or a horizontal expansion program of the investee? Whether the purpose is to enter into a new line of business? Whether it has been formed to comply with a particular regulatory requirement? What is the purpose to enter into collaboration with other entities or persons?

An investor may form a trust to carry out its CSR activities or to implement its ESOP plans or to provide post-employment benefits to its employees. An investee may be incorporated to undertake concession agreements as Public Private Partnership (PPP) model of the government.

4.4.2 Step 2: Design of the investee

One has to look at the structure.

- Is it a firm, trust, listed company, public company, private company, society, SPV etc.?
- Is it controlled through voting rights, shareholders' agreements, convertible instruments, contractual arrangements, exposure to risks & rewards?
- Who takes the decision for the design?

4.4.3 Step 3: Relevant activities of the investee that significantly affect its returns

Relevant activities are the range of operating and financing activities that significantly affect the investee's returns such as (the list is not exhaustive):

- Selling and purchasing of goods & services;
- Managing financial assets during their life;
- Selecting, acquiring or disposing of assets;
- Researching and developing new products or processes;
- Determining a funding structure or obtaining funding;
- Appointment, remuneration and termination of key managerial person.

Not all activities would be relevant at a particular point of time. It depends on the facts and circumstances of the situation. Judgment has to be applied to determine which of the activities are relevant activities at that point of time that significantly affect the investee's return.

Illustration 3: Identification of relevant activities

Entity PS Ltd. issues loan notes to investors in Rupees, but it purchases financial assets in Pound Sterling and USD. It hedges cash flow differences through currency and interest rate swaps. What would be its relevant activities?

Solution

Its relevant activities are as under:

- Selling and purchasing of assets
- Managing financial assets during their life
- Determining a funding structure and obtaining funding for its activities
- Hedging the currency and interest rate risks arising from its activities.

These activities are likely to most significantly affect entity PS's returns

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4.4.4 Step 4: Examining the decision making process for the relevant activities

After having identified the relevant activities that significantly impact the investee's return, the next step is to determine how decision about the particular relevant activity is taken and what is the process of making the decision. Thus in step 4, it is identified, 'Who is the decision maker'.

In some situations, activities both before and after a particular set of circumstances arises or event occurs may be relevant activities. When two or more investors have the current ability to direct relevant activities and those activities occur at different times, the investors shall determine which investor is able to direct the activities that most significantly affect those returns consistently with the treatment of concurrent decision making rights. The investors shall reconsider this assessment over time if relevant facts or circumstances change.

Example: The relevant activity that may have significant impact on the returns of an investee

AB Ltd., which is a scientific research organization is going to appointment the Chief Research Officer.

The key determinant will be who is authorized to appoint the Chief Research Officer. Assuming it is the management committee.

Then one should look, who controls the management committee. AB Limited has two shareholders, A Limited (who holds 60% and controls the Board of Directors) and B Limited (who holds 40% but through a shareholder agreement controls the management committee).

In this case, it may be concluded that B Limited controls AB Limited.

Illustration 4

B Ltd. and C Ltd. had incorporated BC Ltd. to construct & operate a toll bridge. Construction of toll bridge will take 3 years. B Ltd. is responsible for construction. The toll bridge will be operated by C Ltd. Can it be concluded during the construction phase that when B Ltd. has all the authority to take decision that B Ltd. controls BC Ltd.?

Solution

It may appear from the question that B Ltd. has the current ability to direct relevant activities, but this may not be correct. When two or more investors have the current ability to direct relevant activities and those activities occur at different times, the investors shall determine which investor is able to direct the activities that most significantly affect those returns consistently with the treatment of concurrent decision making rights. The investors shall reconsider this assessment over time if relevant facts or circumstances change.

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Illustration 5

In continuation to the facts given in Illustration 2, further if it is given that the toll bridge will be constructed under supervision of NHAI by B Ltd. NHAI will reimburse the cost of construction. B Ltd. is entitled to a margin on the construction but from the cash flows of the toll collection before any payment to C Ltd. The toll revenue will be fixed by C Ltd. who is entitled to management fee. From the toll revenue amount the toll expenses will be paid, then margin will be paid to B Ltd. and then management fee will be paid to C Ltd. The balance will be shared equally by B Ltd. and C Ltd.

Solution

In this case C Ltd. has power since C Ltd. is able to direct the activities that most significantly affect the returns. Cost of construction of bridge that is the responsibility of B Ltd. is reimbursed by NHAI therefore it does not significantly affect the returns. Whereas the significant return to the investor is through toll collection activities being the responsibility of C Ltd.

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4.4.5 Step 5 : Whether the decision maker is empowered and has the right to take those decisions?

1. In step 4, it was identified, 'Who takes the decisions about the relevant activities? It could be the shareholders. It could be the Board of Directors. It could be a contractually appointed person. But the question arises here is that whether the decision maker is empowered?

   In simple situations, the answer may be evident but there are complex situations. Whether the person taking the decision is a principal or infact an agent of the investor; this needs to be examined or the decision making was inherent in the purpose & design of the investee.

   The test is - who has the power?

2. Power arises from rights. Here the rights of the investor have to be examined. The investor should have the **current** ability to direct the relevant activities.

3. **The rights of the investor could be substantive rights or protective rights.** It is a matter of judgment which shall take into consideration all the facts and circumstances. Only substantive rights are to be considered.

1. Substantive rights

- Ownership of more than fifty percent of the voting rights, generally gives an investor the power. But this could be subject to regulatory restrictions, rights held by the other parties. Thus the voting rights may not be substantive.
- To be substantive, rights also need to be exercisable when decisions about the direction of the relevant activities need to be made. Usually, to be substantive, the rights need to be currently exercisable. However, sometimes rights can be substantive, even though the rights are not currently exercisable.

Facts

At the AGM of the investee, decision to direct relevant activities are made. The next shareholders meeting is scheduled in 8 months. However, shareholders individually or collectively holding 5% or more of the voting right can call special meeting to change existing policies or relevant activities, but there is a requirement to give notice to other shareholders atleast 30 days before the meeting. Policies over the relevant activities can be changed only at special or scheduled shareholders' meetings.

Based on the above facts, following three illustrations have been described. Each illustration shall be considered in isolation.

Illustration 6

An investor holds a majority of the voting rights in the investee. Does the investor have current ability to direct the relevant activities given the fact that it takes 30 days to hold shareholder's meeting to take decisions regarding relevant activities?

Solution

The investor's voting rights are substantive because the investor is able to make decisions about the direction of the relevant activities when they need to be made. The fact that it takes 30 days before the investor can exercise its voting rights does not stop the investor from having the current ability to direct the relevant activities from the moment the investor acquires the shareholding.

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Illustration 7

An investor is party to a forward contract to acquire the majority of shares in the investee. The forward contract's settlement date is in 25 days. Is the investor's forward contract a substantive right even before settlement of contract?

Solution

The investor becomes majority shareholder in the investee after the settlement of forward contract in 25 days. As per the facts given in the 'Facts' above, the existing shareholders are unable to change the existing policies over the relevant activities because a special meeting cannot be held for at least 30 days, at which point the forward contract would have been settled. Thus, the investor has rights that are essentially equivalent to the majority shareholder in Illustration 4 above (i.e. the investor holding the forward contract can make decisions about the direction of the relevant activities when they need to be made). Therefore, the investor's forward contract is a substantive right that gives the investor the current ability to direct the relevant activities even before the forward contract is settled.

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Illustration 8

If in the illustration given above, the investor's forward contract shall be settled in 6 months instead of 25 days, would existing shareholders have the current ability to direct the relevant activities?

Solution

Since the date of settlement of forward contact is in 6 months, the existing shareholders can hold a meeting within 30 days and direct relevant activities at which point the forward contract would not be settled. Therefore, the existing shareholders have substantive rights currently.

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Illustration 9

AB Limited owns 50% voting shares in XY Limited. The board of directors of XY Limited consists of six members of which three directors are nominated by AB Limited and three other investors nominate one director each pursuant to a Shareholders' Agreement among them. All decisions concerning 'relevant activities' of XY Limited are taken at its board meeting by a simple majority. As per the articles of association, one of the directors nominated by AB Limited chairs the board meetings and has a casting vote in the event that the directors cannot reach a majority decision. Whether AB Limited has control over XY Limited?

Solution

Paragraph 11 of Ind AS 110 states that, "power arises from rights. Sometimes assessing power is straight forward, such as when power over an investee is obtained directly and solely from the voting rights granted by equity instruments such as shares, and can be assessed by considering the voting rights from those shareholdings. In other cases, the assessment will be more complex and require more than one factor to be considered, for example when power results from one or more contractual arrangements".

Further, paragraph B40 of Appendix B to Ind AS 110 inter alia states that other decision-making rights, in combination with voting rights, can give an investor the current ability to direct the relevant activities. For example, the rights specified in a contractual arrangement in combination with voting rights may be sufficient to give an investor the current ability to direct the manufacturing processes of an investee or to direct other operating or financing activities of an investee that significantly affect the investee's returns.

In the instant case, AB Limited has (though its nominee director who chairs board meetings) a casting vote at the board meetings which along with its 50% (three out of six) of the normal voting rights gives it power to take decisions concerning relevant activities, even if the nominee directors of other investors do not concur with it on any matter. Thus, AB Limited has the current ability to direct the relevant activities of XY Limited through control over board decisions and hence it controls XY Limited.

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Factors that determine whether rights are substantive or not could be classified into three categories:

- **Barriers preventing exercise**

  The decision maker has the rights but barriers exists that prevent the right holder to exercise their rights. These could be economic barriers or other than economic barriers. Thus the rights may not in substance be substantive.

  Examples of barriers include:

  - Heavy financial penalties and incentives
  - High exercise price or conversion price
  - Restrictive terms and conditions
  - Inability to obtain reasonable information for exercising the rights
  - Operational barriers or incenting
  - Prohibitory legal or regulatory environment

- **Exercise requires agreement of other parties**

  The exercise of right may require agreement of other parties. The agreement could be achieved only though a mechanism where all such parties may agree. Absence of such a mechanism may indicate that the rights are not substantive. Also, existence of large number of parties whose agreement is required may be an indication that rights may not be substantive.

- **Benefit accrues to the right holder**

  It has to be identified whether the holder of right is going to be benefitted by exercising the right.

Example:

Suppose A Limited holds in a listed entity C Limited, optionally convertible debentures which are currently exercisable. C Limited is in loss and it is not likely to be in profits for some time in future. The conversion price is much higher than the listed price. The holder would prefer redemption rather than conversion as debentures are out of money. The rights may not be substantive.

2. Protective rights

Protective rights are designed to protect the interests of their holders without giving that party power over the investee to which those rights relate. An investor that holds only protective rights cannot have power or prevent another party from having power over an investee. Protective rights relate to fundamental changes to the activities of an investee or apply in exceptional circumstances.

Examples of protective rights include:

- A lender's right to restrict a borrower from undertaking activities that could significantly change the credit risk of the borrower to the detriment of the lender.
- The right of a party holding a non-controlling interest in an investee to approve capital expenditure greater than that required in the ordinary course of business, or to approve the issue of equity or debt instruments.
- The right of a lender to seize the assets of a borrower if the borrower fails to meet specified loan repayment conditions.

4. The decision maker is thus empowered when he has the substantive rights that gives it current ability to direct the relevant activities. Various indicators of substantive rights, individually or in combination with each other may provide that ability to the investors. These indicators may be clubbed in the following pecking order:

➢ **Primary indicators**

Examples of primary indicators

❖ rights in the form of voting rights (or potential voting rights) of an investee;

❖ rights to appoint, reassign or remove members of an investee's key management personnel who have the ability to direct the relevant activities;

❖ rights to appoint or remove another entity that directs the relevant activities;

❖ rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor; and

- other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities.

- **Priority indicators**

Examples of priority indicators

- The investor can, without having the contractual right to do so, appoint or approve the investee's key management personnel who have the ability to direct the relevant activities.
- The investor can, without having the contractual right to do so, direct the investee to enter into, or can veto any changes to, significant transactions for the benefit of the investor.
- The investor can dominate either the nomination process for electing members of the investee's governing body or obtaining of proxies from other holders of voting rights.
- The investee's key management personnel are related parties of the investor (for example, the chief executive officer of the investee and the chief executive officer of the investor are the same person).
- The majority of the members of the investee's governing body are related parties of the investor.

- **Economic indicators**

Example of economic indicators

- The investee's key management personnel who have the ability to direct the relevant activities are current or previous employees of the investor.
- The investee's operations are dependent on the investor, such as in the following situations:
  - The investee depends on the investor to fund a significant portion of its operations.
  - The investor guarantees a significant portion of the investee's obligations.
  - The investee depends on the investor for critical services, technology, supplies or raw materials.
  - The investor controls assets such as licences or trademarks that are critical to the investee's operations.
  - The investee depends on the investor for key management personnel, such as when the investor's personnel have specialised knowledge of the investee's operations.

- A significant portion of the investee's activities either involve or are conducted on behalf of the investor.

- The investor's exposure, or rights, to returns from its involvement with the investee is disproportionately greater than its voting or other similar rights. For example, there may be a situation in which an investor is entitled, or exposed, to more than half of the returns of the investee but holds less than half of the voting rights of the investee.

5. Voting rights

- Generally, an investor who holds more than half of the voting rights of an investee has the current ability through voting rights to direct the relevant activities in the following situations:

  - the relevant activities are directed by a vote of the holder of the majority of the voting rights, or

  - a majority of the members of the governing body that directs the relevant activities are appointed by a vote of the holder of the majority of the voting rights.

- However, these voting rights should be substantive.

  For example, an investor that has more than half of the voting rights in an investee cannot have power if the relevant activities are subject to direction by a government, court, administrator, receiver, liquidator or regulator.

- An investor can have power even if it holds less than a majority of the voting rights of an investee. An investor can have power with less than a majority of the voting rights of an investee, for example, through:

  - a contractual arrangement between the investor and other vote holders;

  - rights arising from other contractual arrangements;

  - the investor's voting rights;

  - potential voting rights; or

  - a combination of above.

- **Contractual arrangement with other vote holders:**

  A shareholder holding less than majority of the voting power may enter into agreement with other holders of the voting power that may enable it to increase its voting power beyond half. The contractual arrangement might ensure that the investor can direct enough other vote holders on how to vote to enable the investor to make decisions about the relevant activities.

- **Rights from other contractual arrangements:**

  Other decision-making rights, in combination with voting rights, can give an investor the current ability to direct the relevant activities. For example, the rights specified in a contractual arrangement in combination with voting rights may be sufficient to give an investor the current ability to direct the manufacturing processes of an investee or to direct other operating or financing activities of an investee that significantly affect the investee's returns.

However, in the absence of any other rights, economic dependence of an investee on the investor (such as relations of a supplier with its main customer) does not lead to the investor having power over the investee.

- **The investor's voting rights**

  An investor with less than a majority of the voting rights has rights that are sufficient to give it power when the investor has the practical ability to direct the relevant activities unilaterally. When assessing whether an investor's voting rights are sufficient to give it power, an investor considers all facts and circumstances, including:

  - the size of the investor's holding of voting rights relative to the size and dispersion of holdings of the other vote holders, noting that:
    - more the voting rights an investor holds, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities;
    - more the voting rights an investor holds relative to other vote holders, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities;
    - more the parties that would need to act together to outvote the investor, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities;
  - potential voting rights held by the investor, other vote holders or other parties;
  - rights arising from other contractual arrangements; and
  - any additional facts and circumstances that indicate the investor has, or does not have, the current ability to direct the relevant activities at the time that decisions need to be made, including voting patterns at previous shareholders' meetings.

Illustration 10

A Limited has 48% of the voting rights of B Limited. The remaining voting rights are held by thousands of shareholders, none individually holding more than 1 per cent of the voting rights. None of the shareholders has any arrangements to consult any of the others or make collective decisions. Does A Limited have sufficiently dominant voting interest to meet power criterion?

Solution

In the above case, based on the absolute size of A Limited's holding (48%) and the relative size of the other shareholdings, A Limited may conclude that it has a sufficiently dominant voting interest to meet the power criterion.

*****

Illustration 11

An investor A Limited holds 45% of the voting rights of an investee. Eleven other shareholders, each holding 5% of the voting rights of the investee. None of the shareholders has contractual arrangements to consult any of the others or make collective decisions. Can we conclude that investor A Limited has power over the investee?

Solution

In this case, the absolute size of the investor's holding and the relative size of the other shareholdings alone are not conclusive in determining whether the investor has rights sufficient to give it power over the investee. Additional facts and circumstances that may provide evidence that the investor has, or does not have, power shall be considered.

*****

Illustration 12

A Limited holds 48% of the voting rights of B Limited. X Limited and Y Limited each hold 26% of the voting rights of B Limited. There are no other arrangements that affect decision-making. Who has power to take decisions in the present case?

Solution

In this case, the size of A Limited, voting interest and its size relative to the shareholdings of X Limited and Y Limited are sufficient to conclude that A Limited does not have power.

Only two other investors would need to co-operate to be able to prevent investor A from directing the relevant activities of the investee.

*****

Illustration 13

Investor A holds 40% of the voting rights of an investee and six other investors each hold 10% of the voting rights of the investee. A shareholder agreement grants investor A the right to appoint, remove and set the remuneration of management responsible for directing the relevant activities. To change the agreement, a two-thirds majority vote of the shareholders is required. Is the absolute size of the investor's holding and the relative size of the other shareholdings alone is conclusive in determining whether the investor has rights sufficient to give it power?

Solution

No, the absolute size of investor's holding and the relative size of other's shareholdings are not conclusive in determining whether investor has power. Investor A's contractual right to appoint, remove and set the remuneration of management is also to be considered to conclude that it has power over the investee. The fact that investor A might not have exercised this right or the likelihood of investor A exercising its right to select, appoint or remove management shall not be considered when assessing whether investor A has power.

*****

Illustration 14

An investor holds 35% of the voting rights of an investee. Three other shareholders each hold 5% of the voting rights of the investee. The remaining voting rights are held by numerous other shareholders, none individually holding more than 1% of the voting rights. None of the shareholders has arrangements to consult any of the others or make collective decisions. Decisions about the relevant activities of the investee require the approval of a majority of votes cast at relevant shareholders' meetings — 75% of the voting rights of the investee have been cast at recent relevant shareholders' meetings. Does the investor have ability to direct the relevant activities of the investee unilaterally?

Solution

The active participation of other shareholders at recent shareholders' meetings indicates that the investor would not have the practical ability to direct the relevant activities unilaterally, regardless of whether the investor has directed the relevant activities because a sufficient number of other shareholders voted in the same way as the investor.

*****

- **Potential voting rights:**

  Potential voting rights are rights to obtain voting rights of an investee, such as those arising from convertible instruments or options. Those potential voting rights are considered only if the rights are substantive. When considering potential voting rights, an investor shall consider the purpose and design of the instrument, as well as the purpose and design of any other involvement the investor has with the investee. This includes an assessment of the various terms and conditions of the instrument as well as the investor's apparent expectations, motives and reasons for agreeing to those terms and conditions. If the investor also has voting or other decision-making rights relating to the investee's activities, the investor assesses whether those rights, in combination with potential voting rights, give the investor power.

Illustration 15

Entity P Ltd. develops pharmaceutical products. It has acquired 47% of entity S Ltd. with an option to purchase remaining 53%. Entity S is a specialist entity that develops latest technology and does research in pharmaceuticals. Entity P has acquired stake in S Ltd. to complement its own technological research. The remaining 53% is held by key management of P Ltd. who are key to running a major project that will market a medicine with features completely new to the industry. However, if P Ltd. exercises the option the management personnel are likely to leave. They have unique technological knowledge in relation to the specific medicine. Option strike price is 5 times the value of entity's share price. Is the option substantive?

Solution

The option may not be substantive if entity P would derive no economic benefit from exercising it. High strike price and likely loss of key management indicate that the option may not be substantive.

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Illustration 16

AB Ltd holds 40% in BC Ltd. CD Ltd holds 60% in BC Ltd. BC Ltd. is controlled through voting rights. AB Ltd. has call option exercisable in next 3 years for further 40% of investee. The option is deeply out of money and is expected to be the same over the life of the option. Further, investor would not gain any non-financial benefits from the exercise of option. Investor CD has been exercising its votes and is actively directing the relevant activities of the investee. Is right of AB Ltd substantive?

Solution

The option of AB Ltd. is not substantive. This is because although AB Ltd. has current ability to exercise his right to purchase additional voting rights (that, if exercised, would give it a majority of the voting rights in the investee) but option is deeply out of money and is likely to remain so during option period and there are no other benefits gained from the exercise.

*****

Illustration 17

Investor A and two other investors each hold one third of the voting rights of an investee. The investee's business activity is closely related to investor A. In addition to its equity instruments, investor A also holds debt instruments that are convertible into ordinary shares of the investee at any time for a fixed price that is out of the money (but not deeply out of the money). If the debt were converted, investor A would hold 60% of the voting rights of the investee. Investor A would benefit from realizing synergies if the debt instruments were converted into ordinary shares. Does investor A have power over investee?

Solution

Investor A has power over the investee because it holds voting rights of the investee together with substantive potential voting rights that give it the current ability to direct the relevant activities.

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6. There could be situations where it may appear that the investor has no relationship with the investee. Persons controlling investee may have no / distant relationship with the investor. But in fact these persons may be acting as an agent of the investor. The following are examples of such other parties that, by the nature of their relationship, might act as de facto agents for the investor:

- the investor's related parties.
- a party that received its interest in the investee as a contribution or loan from the investor.
- a party that has agreed not to sell, transfer or encumber its interests in the investee without the investor's prior approval (except for situations in which the investor and the other party have the right of prior approval and the rights are based on mutually agreed terms by willing independent parties).
- a party that cannot finance its operations without subordinated financial support from the investor.
- an investee for which the majority of the members of its governing body or for which its key management personnel are the same as those of the investor.
- a party that has a close business relationship with the investor, such as the relationship between a professional service provider and one of its significant clients.

4.4.6 Step 6: Whether investor has exposure, or rights, to variable returns from an investee?

The investor should examine whether it is exposed to or have variable returns from its involvement with the investee. Variable returns are returns that are not fixed and have the potential to vary as a result of the performance of an investee. Variable returns can be only positive, only negative or both positive and negative. An investor assesses whether returns from an investee are variable and how variable those returns are on the basis of the substance of the arrangement and regardless of the legal form of the returns.

For example, an investor can hold a bond with fixed interest payments. The fixed interest payments are variable returns for the purpose of this Ind AS because they are subject to default risk and they expose the investor to the credit risk of the issuer of the bond. The amount of variability (i.e. how variable those returns are) depends on the credit risk of the bond. Similarly, fixed performance fees for managing an investee's assets are variable returns because they expose the investor to the performance risk of the investee. The amount of variability depends on the investee's ability to generate sufficient income to pay the fee.

Examples of returns include:

- Dividends, other distributions of economic benefits from an investee (e.g. interest from debt securities issued by the investee) and changes in the value of the investor's investment in that investee.
- Remuneration for servicing an investee's assets or liabilities, fees and exposure to loss from providing credit or liquidity support, residual interests in the investee's assets and liabilities on liquidation of that investee, tax benefits, and access to future liquidity that an investor has from its involvement with an investee.
- Returns that are not available to other interest holders. For example, an investor might use its assets in combination with the assets of the investee, such as combining operating

functions to achieve economies of scale, cost savings, sourcing scarce products, gaining access to proprietary knowledge or limiting some operations or assets, to enhance the value of the investor's other assets.

4.4.7 Step 7: Is there a link between power & returns?

Illustration 18

A decision maker (fund manager) establishes, markets and manages a publicly traded, regulated fund according to narrowly defined parameters set out in the investment mandate as required by its local laws and regulations. The fund was marketed to the investors as an investment in a diversified portfolio of equity securities of publicly traded entities. Within the defined parameters, the fund manager has discretion about the assets in which to invest. The fund manager has made a 10% pro rata investment in the fund and receives a market-based fee for its services equal to 1% of the net asset value of the fund. The fees are commensurate with the services provided. The fund manager does not have any obligation to fund losses beyond its 10% investment. The fund is not required to establish, and has not established, an independent board of directors. The investors do not hold any substantive rights that would affect the decision-making authority of the fund manager, but can redeem their interests within particular limits set by the fund. Does the fund manager have control over the fund?

Solution

Although operating within the parameters set out in the investment mandate and in accordance with the regulatory requirements, the fund manager has decision-making rights that give it the current ability to direct the relevant activities of the fund — the investors do not hold substantive rights that could affect the fund manager's decision-making authority. The fund manager receives a market-based fee for its services that is commensurate with the services provided and has also made a pro rata investment in the fund. The remuneration and its investment expose the fund manager to variability of returns from the activities of the fund without creating exposure that is of such significance that it indicates that the fund manager is a principal.

Consideration of the fund manager's exposure to variability of returns from the fund together with its decision-making authority within restricted parameters indicates that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund.

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Example

A decision maker establishes, markets and manages a fund that provides investment opportunities to a number of investors. The decision maker (fund manager) must make decisions in the best interests of all investors and in accordance with the fund's governing agreements. Nonetheless, the fund manager has wide decision-making discretion. The fund manager receives a market-based fee for its services equal to 1 per cent of assets under management and 20 per cent of all the fund's profits if a specified profit level is achieved. The fees are commensurate with the services provided.

Although it must make decisions in the best interests of all investors, the fund manager has extensive decision-making authority to direct the relevant activities of the fund. The fund manager is paid fixed and performance-related fees that are commensurate with the services provided. In addition, the remuneration aligns the interests of the fund manager with those of the other investors to increase the value of the fund, without creating exposure to variability of returns from the activities of the fund that is of such significance that the remuneration, when considered in isolation, indicates that the fund manager is a principal. The above fact pattern and analysis applies to Illustrations 16, 17 and 18 described below. Each illustration is considered in isolation.

Illustration 19

The fund manager also has a 2 per cent investment in the fund that aligns its interests with those of the other investors. The fund manager does not have any obligation to fund losses beyond its 2 per cent investment. The investors can remove the fund manager by a simple majority vote, but only for breach of contract. Considering the facts given, does the fund manager control the fund?

Solution

The fund manager's 2 per cent investment increases its exposure to variability of returns from the activities of the fund without creating exposure that is of such significance that it indicates that the fund manager is a principal. The other investors' rights to remove the fund manager are considered to be protective rights because they are exercisable only for breach of contract. Although the fund manager has extensive decision-making authority and is exposed to variability of returns from its interest and remuneration, the fund manager's exposure indicates that the fund manager is an agent. Thus, in these circumstances we conclude fund manager does not control the fund.

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Illustration 20

The fund manager has a more substantial pro rata investment in the fund, but does not have any obligation to fund losses beyond that investment. The investors can remove the fund manager by a simple majority vote, but only for breach of contract. Does the fund manager in this case control the fund?

Solution

The other investors' rights to remove the fund manager are considered to be protective rights because they are exercisable only for breach of contract. Although the fund manager is paid fixed and performance-related fees that are commensurate with the services provided, the combination of the fund manager's investment (i.e. substantial pro rata investment) together with its remuneration could create exposure to variability of returns from the activities of the fund that is of such significance that it indicates that the fund manager is a principal. The greater the magnitude of, and variability associated with, the fund manager's economic interests (considering its remuneration and other interests in aggregate), the more emphasis the fund manager would place on those economic interests in the analysis, and the more likely the fund manager is a principal. Therefore, we conclude that the fund manager controls the fund.

Note: Having considered fund manager's remuneration and the other factors, we might consider a 20 per cent investment to be sufficient to conclude that it controls the fund. However, in different circumstances (i.e. if the remuneration or other factors are different), control may arise when the level of investment is different.

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Illustration 21

The fund manager has a 20% pro rata investment in the fund, but does not have any obligation to fund losses beyond its 20% investment. The fund has a board of directors, all of whose members are independent of the fund manager and are appointed by the other investors. The board appoints the fund manager annually. If the board decided not to renew the fund manager's contract, the services performed by the fund manager could be performed by other managers in the industry. Does the fund manager control the fund?

Solution

Although the fund manager is paid fixed and performance-related fees that are commensurate with the services provided, the combination of the fund manager's 20% investment together with its remuneration creates exposure to variability of returns from the activities of the fund that is of such significance that it indicates that the fund manager is a principal. However, the investors have substantive rights to remove the fund manager — the board of directors provides a mechanism to ensure that the investors can remove the fund manager if they decide to do so. In this example, the fund manager places greater emphasis on the substantive removal rights in the analysis. Thus, although the fund manager has extensive decision-making authority and is exposed to variability of returns of the fund from its remuneration and investment, the substantive rights held by the other investors indicate that the fund manager is an agent. Thus, we conclude that it does not control the fund.

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Illustration 22

An investee Noor Ltd. is floated to invest in a portfolio of equity oriented mutual funds, funded by fixed rate debentures and equity instruments. The equity instruments will receive any residual returns of the investee. The transaction was marketed to potential debt investors as an investment in a portfolio of asset-backed securities with exposure to the credit risk associated with the possible default of the issuers of the asset-backed securities in the portfolio and to the interest rate risk associated with the management of the portfolio. On formation, the equity instruments represent 15% of the value of the assets purchased by Noor Ltd. A decision maker (the asset manager) of Noor Ltd. manages the portfolio by making investment decisions strictly as per investee's prospectus. For services rendered by manager, receives a fixed fee (i.e. 0.5 percent of assets under management) and performance-related fee (i.e. 2 percent of profits) if profits exceed 10% over & above of previous financial year. The asset manager holds 40 per cent of the equity in the investee. The remaining 60 per cent of the equity, and all the debentures are held by a large number of widely dispersed unrelated third party investors. The asset manager can be removed, without cause, by a simple majority decision of the other investors.

Solution

The asset manager is paid fixed and performance-related fees that depends on variability of portfolio performance backed by equity oriented mutual funds i.e the remuneration and interest of other investors aligns to increase the value of the fund. The asset manager has exposure to variability of returns from the relevant activities of the fund because it holds 40 per cent of the equity and from its remuneration.

Although operating within the guidelines set out in the investee's prospectus, the asset manager has the current ability to make investment decisions that significantly affect the investee's returns — the removal rights held by widely unrelated dispersed investors receive little weighting because those rights are held by a large number of widely unrelated dispersed investors.

In given illustration, the asset manager has greater exposure to variability of returns of the fund from its 40 per cent equity interest, which is subordinate to the debt instruments. Holding 40 per cent of the equity creates exposure to losses and rights to returns of the investee, which are of such significance that it indicates that the asset manager is a principal and not mere an agent.

Therefore, it is concluded that the asset manager controls the investee Noor Ltd.

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Illustration 23

A decision maker Aditya Birla Money Ltd. (ABML) sponsors a debt oriented mutual fund, which issues its units instruments to unrelated third party investors. The transaction was marketed as an investment in a portfolio of highly AAA rated long-term & medium-term assets with minimal credit risk exposure of the assets in the portfolio. Various transferors sell above long term & medium-term asset portfolios to the fund. Each transferor services the portfolio of assets that it sells to the fund and manages receivables on default for a market-based servicing fee. Each transferor also provides first loss protection against credit losses from its asset portfolio through over-collateralization of the assets transferred to the fund. The sponsor (ABML) establishes the terms of the fund and manages the operations of the fund for a market-based fee. The sponsor (ABML) approves the sellers permitted to sell to the fund, approves the assets to be purchased by the fund and makes decisions about the funding of the fund. The sponsor is entitled to any residual return of the fund and also provides liquidity facilities to the fund. The credit enhancement provided by the sponsor absorbs losses of up to 5 per cent of all of the funds fund's assets, after losses are absorbed by the transferors. The liquidity facilities are not advanced against defaulted assets. The investors do not hold substantive rights that could affect the decision-making authority of the sponsor.

Solution

Even though the sponsor is paid a market-based fee for its services that is commensurate with the services provided, the sponsor has exposure to variability of returns from the activities of the fund because of its rights to any residual returns of the fund and the provision of credit enhancement and liquidity facilities (ie the fund is exposed to liquidity risk by using short-term debt instruments to fund medium-term assets). Even though each of the transferors has decision-making rights that affect the value of the assets of the fund, the sponsor has extensive decision-making authority that gives it the current ability to direct the activities that most significantly affect the fund's returns (ie the sponsor established the terms of the fund, has the right to make decisions about the assets (approving the assets purchased and the transferors of those assets) and the funding of the fund (for which new investment must be found on a regular basis)). The right to residual returns of the fund and the provision of credit enhancement and liquidity facilities expose the sponsor to variability of returns from the activities of the fund that is different from that of the other investors. Accordingly, that exposure indicates that the sponsor is a principal and thus the sponsor concludes that it controls the fund. The sponsor's obligation to act in the best interest of all investors does not prevent the sponsor from being a principal.

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4.5 COMPARISON OF IND AS WITH THE COMPANIES ACT, 2013

1. Section 2(46) defines holding company as under:
   - "holding company", in relation to one or more other companies, means a company of which such companies are subsidiary companies;
2. Section 2(87) defines subsidiary as under:
   - "subsidiary company" or "subsidiary", in relation to any other company (that is to say the holding company), means a company in which the holding company—
     (i) controls the composition of the Board of Directors; or
     (ii) exercises or controls more than one-half of the total share capital either at its own or together with one or more of its subsidiary companies.

     Provided that such class or classes of holding companies as may be prescribed shall not have layers of subsidiaries beyond such numbers as may be prescribed.

     Explanation—For the purposes of this clause—

     (a) a company shall be deemed to be a subsidiary company of the holding company even if the control referred to in sub-clause (*i*) or sub-clause (*ii*) is of another subsidiary company of the holding company;

     (b) the composition of a company's Board of Directors shall be deemed to be controlled by another company if that other company by exercise of some power exercisable by it at its discretion can appoint or remove all or a majority of the directors;
3. Section 2(6) defines associate as under:
   - "associate company", in relation to another company, means a company in which that other company has a significant influence, but which is not a subsidiary company of the company having such influence and includes a joint venture company.

Explanation — For the purposes of this clause, “significant influence” means control of at least twenty per cent of total share capital, or of business decisions under an agreement;

- Joint venture is not defined in the Companies Act, 2013.

4. Section 2(27) defines control as under:

- “control” shall include the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders’ agreements or voting agreements or in any other manner;

  Analysis of ‘Control’ as per the Companies Act, 2013:

  “Control” shall include:

  - the right to appoint majority of the directors or
  - to control the management or policy decisions

    exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their:

  - shareholding rights; or
  - management rights; or
  - shareholders’ agreements; or
  - voting agreements; or
  - in any other manner;

- Certain key attributes of the definition:

  - It is an inclusive definition;
  - 2 situations are mentioned:
    - First: Right to appoint majority of directors. This finds a mention in the definition of subsidiary also;
    - Second: Control the management or policy decisions
  - Control can be exercised individually or with somebody;
  - Control can be exercised directly or indirectly (through somebody who is under control – like in a principal / agent relationship);
  - Control can be obtained in a variety of manners.

4.6 CONSOLIDATED FINANCIAL STATEMENTS - INVESTMENT ENTITIES

4.6.1 Identification

Parent shall determine whether it is an investment entity.

4.6.1.1 As per Ind AS 110, Investment entity is an entity:

a. That obtains funds from investors for providing investment management services to those investors;

b. Whose business purpose is to invest funds solely for returns from capital appreciation, investment income, or both as committed to its investor;

c. Which Measures and evaluates the performance of substantially all of its investments on a fair value basis.

4.6.1.2 Documents that indicate entity's objective are:

i memorandum,

ii publications distributed by the entity and

iii other corporate or partnership documents,

4.6.1.3 Entity may also participate in many investment related activities:

i Providing management services & strategic advice to investee

ii Providing financial support like giving loan or providing capital commitments or guarantee

4.6.1.4 In order to demonstrate that it meets this element of the definition, an investment entity:

i provides investors with fair value information

ii reports fair value information internally to the entity's key management personnel.

4.6.1.5 For assessing 'Investment entity', an entity also has to consider some typical characteristics as declared below (however absence of any characteristic does not necessarily disqualify an entity from being an investment entity):

a. Whether it has more than one investment:

In some cases, holding one investment does not prevent it from meeting definition if the entity:

i is in start-up period;

ii has not yet made investment to replace those dispose of;

iii is established to pool investor fund to invest in single investment under certain circumstances;

iv is in process of liquidation

b. Whether it has more than one investor:

In some cases having one investor does not prevent the entity from meeting definition if the entity:

i is within its initial offering period & entity is still identifying suitable investor;

ii has not identified suitable investor to replace ownership interest that have been redeemed

iii is in process of liquidation

c. Whether its Investors are not related parties of the entity:

- Having unrelated investors would make it less likely that the entity, or other members of the group containing the entity, would obtain benefits other than capital appreciation or investment income
- However, an entity may still qualify as an investment entity even though its investors are related to the entity.

For example, an investment entity may set up a separate 'parallel' fund for a group of its employees (such as key management personnel) or other related party investor(s), which mirrors the investments of the entity's main investment fund. This 'parallel' fund may qualify as an investment entity even though all of its investors are related parties.

d. Whether it has ownership interests in the form of equity or similar interest:

An entity that has significant ownership interests in the form of debt that, may still qualify as an investment entity, provided that the debt holders are exposed to variable returns from changes in the fair value of the entity's net assets.

In assessing whether an entity is an investment entity the following three steps may be performed.

Step 1: Whether it meets the three elements of the definitions

Step 2: Whether it meets all the four typical characteristics

Step 3: If it does not meet all the four typical characteristics, whether it still is investment entity based on the presumption of substance over form.

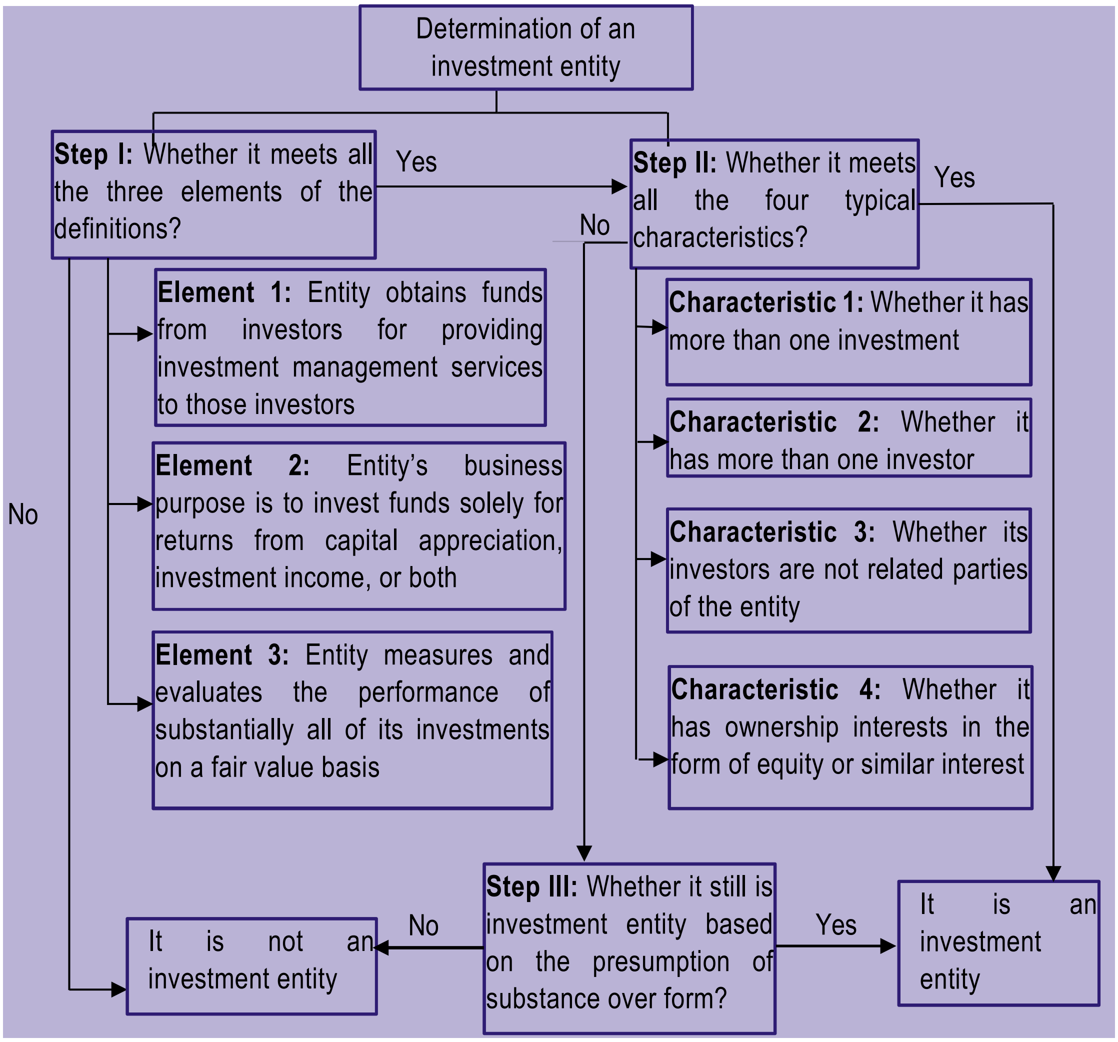

Illustration 24

A fund has been set up by its manager; initially the manager is the only shareholder. As at its first period end, the fund has not been successful in receiving funds from other prospective shareholders; but it is actively soliciting new investors. The fund invests in global equities and equity-related derivatives; and it provides its one shareholder with investment management services (as mandated in its prospectus). Its prospectus states that it expects to buy and sell investments regularly, and it expects holding periods of more than one year to be rare.

The fund generates returns from capital appreciations and investment income in the form of dividends. The fund fair values all investments and these valuations are the basis for subscriptions and redemptions into and out of the fund. Subscriptions and redemptions can occur daily.

Is the fund an investment entity?

Solution

The fund is an investment entity. It meets the definition of an investment entity:

- It has been set up to provide investment management services to its investors. For this period, it has only one manager-shareholder and so it is providing investment management services to itself, but this is not its longer-term manager intention.
- It is carrying on its investment activities with the objective of capital appreciation and investment income.
- It measures its underlying investments on a fair value basis and fair value is the basis for subscriptions and redemptions into and out of the fund.

The fund displays the following characteristics:

- It holds multiple investments.
- It does not have multiple investors; but, this is expected to be temporary and the fund manager is actively soliciting new investors.
- It does not have unrelated investors, because it has only a single investor.
- It issues ownership interests in the form of redeemable units that entitle the holders to a share of net assets.

Although the fund has a single investor, this is expected to be temporary. Failing to meet this typical characteristic does not mean that the fund is not an investment entity. In the context of the definition and the fund's overall business purpose, it is an investment entity. The fund is required to make appropriate disclosures in its financial statements on why it qualifies as an investment entity even when it has only one investor.

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Illustration 25

A fund is set up by a corporate entity that runs a power plant. The corporate entity (which owns all of the units in the fund) needs to keep funds available in case of a technical failure of the power plant. The entity does not have the expertise to manage the fund, so it appoints a third party asset manager. The entity can remove the fund manager on four months' notice.

The fund invests in traded equity and debt instruments (as set out in the investment management agreement and fund founding documents) and its maximum exposure to one investment is not more than 11% of monies invested. The objective of the fund is to generate returns either from dividends and interest or from selling the instruments. The fund does not invest in the power industry and the corporate entity has no other relationship with the fund; for example, it does not have options to buy any of the investments made by the fund.

The fund reports fair value information internally and to its corporate parent; and its performance is evaluated against a benchmark stock exchange index.

The fund issues units that are redeemable at any time. The redeemable shares pay the net asset value of the fund when liquidated, and they are accounted for by the fund as equity under Ind AS 32. The units do not carry voting rights.

Is the fund an investment entity? How does the corporate entity account for its interest in the fund?

Solution

The fund is an investment entity. It meets the definition of an investment entity to the extent that:

- It provides investment management services to its investor.
- Its business purpose is to invest in debt and equity instruments for capital appreciation and investment income.
- It measures and evaluates the performance of its investments on a fair value basis.

The fund displays two of the four typical characteristics

- The fund holds multiple investments.
- The fund only has one investor but in these circumstances that is not inconsistent with its overall business purpose and with the definition of an investment entity.
- The fund does not have unrelated investors, because there is only one investor; but, again, in these circumstances this is not inconsistent with the definition of an investment entity.
- Units issued by the fund entitle the holder to a proportionate share of the net asset value of the fund.

Two of the characteristics are not satisfied because the fund has a single investor. When examining all the facts and circumstances, however, the fund concludes that it is an investment entity and that the failure to meet two of the typical characteristics is not inconsistent with the definition.

The corporate entity is not an investment entity. It consolidates the fund (including any controlled investments made by the fund).

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Illustration 26

An entity, X Limited, is formed by Z Limited to invest in start-up technology companies for capital appreciation. Z Limited holds a 75% interest in X Limited and controls it; the other 25% ownership interest is held by 10 unrelated investors. Z Limited holds options to acquire investments held by X Limited, at their fair value, which would be exercised if the technology developed by the investees would benefit the operations of Z Limited.

Whether X Limited meet the definition of an investment entity as per Ind AS 110?

Solution

Paragraph 27 of Ind AS 110 states that a parent has to determine whether an entity is an investment entity. An investment entity is an entity that:

(a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;

(b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and

(c) measures and evaluates the performance of substantially all of its investments on a fair value basis."

Further, paragraph B85I *inter-alia* states that an entity is not investing solely for capital appreciation, investment income or both, if the entity or another member of the group containing the entity obtains, or has the objective of obtaining, other benefits from the entity's investments that are not available to other parties that are not related to the investee. Such benefits include the acquisition, use, exchange or exploitation of the processes, assets or technology of an investee. This would include the entity or another group member having disproportionate, or exclusive, rights to acquire assets, technology, products or services of any investee; for example, by holding an option to purchase an asset from an investee if the asset's development is deemed successful.

Additionally, paragraph B85F of Ind AS 110 *inter-alia* states that an entity's investment plans also provide evidence of its business purpose. One feature that differentiates an investment entity from other entities is that an investment entity does not plan to hold its investments indefinitely; it holds them for a limited period. Since equity investments and non-financial asset investments have the potential to be held indefinitely, an investment entity shall have an exit strategy documenting how the entity plans to realise capital appreciation from substantially all of its equity investments and non-financial asset investments".

The absence of an exit strategy for investments in subsidiaries also suggests that the investments are made not only for investment returns (capital appreciation, investment income or both) but also other benefits (such as those arising from synergies).

In the instant case, although X's business purpose is investing for capital appreciation and it provides investment management services to its investors, X Limited is not an investment entity since:

— Z Limited, the parent of X Limited, has an option to acquire investments in investees held by X Limited, if assets developed by the investees would benefit the operations of Z Limited. This provides other benefits in addition to capital appreciation and investment income; and

— the investment plans of X Limited do not include exit strategies for its investments, which are equity instruments. The options held by Z Limited are not controlled by X Limited and do not constitute an exit strategy.

Since X Limited is not an investment entity, it will be required to consolidate its subsidiaries.

4.6.2 Reassessing Status of an entity (investment entity or not)

- If there are changes in one or more of the three elements of the definition; or
- If there are changes in one or more of the four typical characteristics

Then,

Account for change (if any in status) prospectively, whether from investment entity to normal entity or vice versa.

Example:

Due to change in market conditions, investors in a fund are redeeming their units. As a result of this redemption, one significant investor remains in the fund. The fund should reassess its investment entity status. In this case, the fund might continue to meet the definition and remain an investment entity, in either of the following situations: if its business continues to be management of investments for capital appreciation and/or income, but now for one investor instead of many; or if it expects that this will be temporary situation.

4.6.3 Consolidation not required

- An investment entity shall not consolidate its subsidiaries.
- Instead it shall measure its investment in subsidiaries at fair value through profit or loss in accordance with Ind AS 109.

There are two exceptions to the said rule:

i An investment entity shall consolidate that subsidiary which provides services related to investment entity's investment activities.

ii A parent of an investment entity shall consolidate all entities that it controls, including those controlled through an investment entity subsidiary, unless the parent itself is an investment entity.

UNIT 5 : CONSOLIDATED FINANCIAL STATEMENTS : ACCOUNTING OF SUBSIDIARIES

5.1 STATUTORY REQIUIREMENTS

5.1.1 The Companies Act, 2013 requirements

Section 129 sub-section (3) & (4) of the Companies Act, 2013 provides for the consolidation of accounts. The relevant text is as under:

- **129 (3) :** Where a company has one or more subsidiaries, it shall, in addition to financial statements provided under sub–section (2), prepare a consolidated financial statement of the company and all its subsidiaries in the same form and manner as that of its own which shall also be laid before the annual general meeting of the company along with the laying of its financial statement under sub–section (2).

  Provided that the company shall also attach along with its financial statement a separate statement containing the salient features of the financial statement of its subsidiary or subsidiaries in such form as may be prescribed.

  Provided further that the Central Government may provide for the consolidation of accounts of companies in such manner as may be prescribed.

  Explanation: For the purpose of this sub–section, the word 'subsidiary' shall include associate and joint venture.

- **129 (4):** The provisions of this Act, applicable to the preparation, adoption and audit of the financial statements of a holding company shall, mutatis mutandis, apply to the consolidated financial statements referred to in sub-section (3).

5.1.2 The Companies (Accounts) Rules, 2014

The relevant rules are rules 5 & 6 of the Companies (Accounts) Rules, 2014. The relevant extracts of these rules are reproduced as under:

- **Form of statement containing salient features of financial statements of subsidiaries – Rule 5 :** The statement containing the salient features of the financial statement of a company's subsidiary or subsidiaries, associate company or companies and joint venture or ventures under the first proviso to sub–section (3) of section 129 shall be in Form AOC – 1 (appended as Annexure I at the end of this chapter).

- **Manner of consolidation of accounts – Rule 6 :** The consolidation of financial statements of the company shall be made in accordance with the
  - provisions of Schedule III of the Act and
  - the applicable standards.

Provided that in case of a company covered under sub–section (3) of section 129 which is not required to prepare consolidated financial statements under the Accounting Standards, it shall be sufficient if the company complies with provisions on consolidated financial statements provided in Schedule III of the Act. (Refer Annexure II at the end of the chapter)

Provided further that nothing in this rule shall apply in respect of preparation of consolidated financial statements by a company if it meets the following conditions:

i It is a wholly owned subsidiary or is a partially owned subsidiary of another company and all its members, including those not otherwise entitled to vote, having been intimated in writing and for which proof of delivery of such intimation is available with the company, do not object to the company not presenting consolidated financial statements;

ii It is a company whose securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India; and

iii Its ultimate or any intermediate holding company files consolidated financial statements with the Registrar which are in compliance with the applicable Accounting Standards.

5.2 COMPONENTS OF CONSOLIDATED FINANCIAL STATEMENTS

Ind AS 110, 'Consolidated Financial Statements' and Division II of Schedule III to the Companies Act, 2013 (Refer Annexure II) should be applied in the preparation and presentation of consolidated financial statements which includes:

i Consolidated Balance Sheet;

ii Consolidated Statement of Profit and Loss;

iii Consolidated Statement of Changes in Equity;

iv Consolidated Cash Flow Statement;

v Consolidated Notes to the Financial Statements.

When a company is required to prepare Consolidated Financial Statements, the company shall mutatis mutandis follow the requirements of Schedule III to the Companies Act, 2013 as applicable to a company in the preparation of balance sheet, statement of changes in equity and statement of profit and loss in addition, the consolidated financial statements shall disclose the information as per the requirements specified in the applicable Indian Accounting Standards notified under the Companies (Indian Accounting Standards) Rules, 2015. In addition, the company shall disclose additional information as required by Ind AS 27 and Ind AS 112 (Refer Unit 8).

5.3 CONSOLIDATION PROCEDURES

5.3.1 Process

1. Consolidation of an investee shall begin from the date the investor obtains control of the investee and cease when the investor loses control of the investee.
2. Consolidated financial statements:
   - combine like items of assets, liabilities, equity, income, expenses and cash flows of the parent with those of its subsidiaries.
   - offset (eliminate) the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary (Ind AS 103 'Business Combination' explains how to account for any related goodwill).
   - eliminate in full intragroup assets and liabilities, equity, income, expenses and cash flows relating to transactions between entities of the group (profits or losses resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets, are eliminated in full).
3. Intragroup losses may indicate an impairment that requires recognition in the consolidated financial statements.
4. Ind AS 12, Income Taxes, applies to temporary differences that arise from the elimination of profits and losses resulting from intragroup transactions.

5.3.2 Calculation of goodwill / capital reserve

1. It will be useful to refer the provisions of Ind AS 103, 'Business Combinations' when computing the goodwill / capital reserve in the case of acquisition of a subsidiary. As per Ind AS 103:
   - Business combination is a transaction or other event in which an acquirer obtains control of one or more businesses;
   - Non–controlling interest is the equity not attributable, directly or indirectly, to a parent.
2. As per para 32 of Ind AS 103, the acquirer shall recognize goodwill as of the acquisition date measured as the excess of (a) over (b) below:

   (a) the aggregate of:

   (i) the consideration transferred is measured in accordance with Ind AS 103, which generally requires acquisition-date fair value; and

   (ii) the amount of any non-controlling interest in the subsidiary measured in accordance with Ind AS 103;

   (b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with Ind AS 103.

3. As per para 19 of Ind AS 103, for each acquisition of a subsidiary, the investor shall measure at the acquisition date components of non-controlling interest in the subsidiary that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation at either:

   (a) Fair value; or

   (b) The present ownership instruments' proportionate share in the recognized amounts of the subsidiary's identifiable net assets.

4. The computation of goodwill / bargain purchase price (capital reserve) involves following steps:

   Step 1 : Determine the fair value of consideration transferred by the parent

   Step 2 : Determine the amount of non–controlling interest

   - This can be computed by two methods:

   As per method 1 : 'Fair Value method' - compute the fair value of non–controlling interest.

   Example:

   A Limited acquires 80% of B Limited at a valuation of ₹ 130.00 crore (excluding control premium) by payment in cash of ₹ 120.00 crore. The value of non–controlling interest is ₹ 30 crore.

   As per method 2 : 'Proportionate Share method'

   Example: Continuing with the above example in method 1

   Assume that the value of recognized amount of subsidiary's identifiable net assets is ₹ 130.00 crore, as determined in accordance with Ind AS 103. The value of non–controlling interest is ₹ 26.00 crore (i.e. ₹ 130 crore x 20%).

   Step 3: The value of recognized amount of subsidiary's identifiable net assets, as determined in accordance with Ind AS 103

   Step 4 : Determine goodwill / bargain purchase price:

   - Goodwill arises where aggregate of amount determined in step 1 and step 2 exceeds amount determined in step 3.

   In the aforesaid example, as per method 1, goodwill is determined at ₹ 20.00 crore whereas as per method 2, the amount of goodwill is ₹ 16.00 crore

Method 1 – Fair Value Method		**(All figures in crore)**	
		Dr.	Cr.
Net Identifiable Assets	Dr.	130.00	
Goodwill (Balancing figure)	Dr.	20.00	
To Consideration payable			120.00
To Non–controlling Interest			30.00

Method 2 – Proportionate Share Method			(All figures in crore)
		Dr.	Cr.
Net Identifiable Assets	Dr.	130.00	
Goodwill (Balancing figure)	Dr.	16.00	
To Consideration payable			120.00
To Non–controlling Interest			26.00

- Bargain purchase price (capital reserve) arises when amount determined in step 3 exceeds aggregate of amount determined in step 1 and step 2.

Example:

In the aforesaid example, if the consideration is ₹ 90 instead of ₹ 120.00 crore, then the amount of bargain purchase is determined at ₹ 10.00 crore whereas as per method 2, the amount of bargain purchase is ₹ 14.00 crore.

Method 1 – Fair Value Method			(All figures in crore)
		Dr.	Cr.
Net Identifiable Assets	Dr.	130.00	
To Bargain Purchase Price (included in consideration)			10.00
To Consideration payable			90.00
To Non–controlling Interest			30.00
Method 2 – Proportionate Share Method			**(All figures in crore)**
		Dr.	Cr.
Net Identifiable Assets	Dr.	130.00	
To Bargain Purchase Price (included in consideration)			14.00
To Consideration payable			90.00
To Non–controlling Interest			26.00

Illustration 1: Goodwill recognised depends on how NCI is measured.

Ram Ltd. acquires Shyam Ltd. by purchasing 60% of its equity for ₹ 15 lakh in cash. The fair value of non-controlling interest is determined as ₹ 10 lakh. The net aggregate value of identifiable assets and liabilities, as measured in accordance with Ind AS 103 is determined as ₹ 5 lakh.

How much goodwill is recognized based on two measurement bases of non-controlling interest (NCI)?

Solution

A. NCI is measured at NCI's proportionate share of the acquiree's identifiable net assets

Ram Ltd. recognizes 100% of the identifiable net assets on the acquisition date and decides to measure NCI at proportionate share (40%) of Shyam Ltd. identifiable net assets.

The journal entry recorded on the acquisition date for the 60% interest acquired is as follows:

(in lakhs)

		Dr. (₹ in lakh)	Cr. (₹ in lakh)
Identifiable net assets	Dr.	5	
Goodwill (Balancing figure)	Dr.	12	
To Cash			15
To NCI			2

NCI is (₹ 5 lakh x 40%) = ₹ 2 lakh. Hence, goodwill of ₹ 12 lakh is calculated as consideration ₹ 15 lakh plus NCI ₹ 2 lakh less identifiable net assets and liabilities ₹ 5 lakh.

The goodwill recognized under Ind AS 103, therefore, represents entity A's 60% share of the total goodwill attributable to Shyam Ltd. It does not include any amount of goodwill attributable to 40% NCI.

B. NCI is measured at fair value

The facts are as above, but Ram Ltd decides to measure NCI at fair value rather than at its share of identifiable net assets.

The fair value of NCI is determined as ₹ 10 lakh (given in the question), which is the same as the fair value on a per-share basis of the purchased interest.

The acquirer recognizes at the acquisition date

(i) 100% of the identifiable net assets,

(ii) NCI at fair value, and

(iii) Goodwill.

The journal entry recorded on the acquisition date for the 60% interest acquired is as follows:

		Dr. (₹ in lakh)	Cr. (₹ in lakh)
Identifiable net assets	Dr.	5	
Goodwill (Balancing figure)	Dr.	20	
To Cash			15
To NCI			10

Therefore, goodwill recognized where NCI is measured at fair value as per Ind AS 103 represents the group's share to total goodwill attributable to Shyam Ltd. and the NCI's share of the total goodwill attributable to Shyam Ltd.

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Illustration 2: Gain on a bargain purchase when NCI is measured at fair value

Seeta Ltd. acquires Geeta Ltd. by purchasing 70% of its equity for ₹ 15 lakh in cash. The fair value of NCI is determined as ₹ 6.9 lakh. Management have elected to adopt full goodwill method and to measure NCI at fair value. The net aggregate value of the identifiable assets and liabilities, as measured in accordance with the standard is determined as ₹ 22 lakh. (Tax consequences being ignored).

Solution

The bargain purchase gain is calculated as follows:

	(₹ in lakh)
Fair value of consideration transferred	15.00
Fair value of NCI	6.90
Fair value of previously held equity interest	n/a
	21.90
Less: Recognised value of 100% of the net identifiable assets, measured in accordance with the standards	(22.00)
Gain on bargain purchase	(0.10)

The recognized amount of the identifiable net assets is greater than the fair value of the consideration transferred plus fair value of NCI. Therefore, a bargain purchase gain of ₹ 0.10 lakh is either recognised in OCI and accumulated in equity as capital reserve or directly in equity as capital reserve.

The journal entry recorded on the acquisition date for 70% interest is as follows:

		Dr. (₹ in lakh)	Cr. (₹ in lakh)
Identifiable net assets	Dr.	22.00	
To Cash			15.00
To Gain on bargain purchase			0.10
To NCI			6.90

Since NCI is required to be recorded at fair value, a bargain purchase is recognized for ₹ 0.1 lakh.

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Illustration 3: Gain on a bargain purchase when NCI is measured at proportionate share of identifiable net assets.

Continuing the facts as stated in the above illustration, except that Seeta Ltd. chooses to measure NCI using a proportionate share method for this business combination. (Tax consequences have been ignored).

Solution

This method calculates the bargain purchase same as under the fair value method, except that NCI is measured as the proportionate share of the identifiable net assets.

The bargain purchase gain is as follows:

	(₹ in lakh)
Fair value of consideration transferred	15.00
Fair value of NCI (30% of ₹ 22.0 lakh)	6.60
Fair value of previously held equity interest	N/A
	21.60
Less: Recognised value of 100% of the net identifiable assets, measured in accordance with the standards	(22.00)
Gain on bargain purchase	(0.40)

As the recognized amount of the identifiable net assets is greater than the fair value of consideration transferred, plus the recognized amount of NCI (at proportionate share), a bargain purchase gain of ₹ 0.4 lakh is either recognised in OCI and accumulated in equity as capital reserve or directly in equity as capital reserve.

The journal entry recorded on the acquisition date for 70% interest is as follows:

		Dr. (₹ in lakh)	Cr. (₹ in lakh)
Identifiable net assets	Dr.	22.0	
To Cash			15.0
To Gain on bargain purchase			0.4
To NCI			6.6

Under the proportionate share method, NCI is recorded at its proportionate share of its net identifiable assets and not at fair value.

*****

Illustration 4: Measurement of goodwill when there is no non-controlling interest

X Ltd. acquired Y Ltd. on payment of ₹ 25 crore cash and transferring a retail business, the fair value of which is ₹ 15 crore. Assets acquired and liabilities assumed in the acquisition are ₹ 36 crore.

Find out the Goodwill.

Solution

	(All figures are ₹ in crore)
Fair value of the consideration paid (₹ 25 cr + ₹ 15 cr)	40
Fair value of assets acquired net of fair value of liabilities assumed	(36)
Goodwill	4

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Illustration 5: Measurement of goodwill when there is non-controlling interest

Raja Ltd. purchased 60% shares of Ram Ltd. paying ₹ 525 lakh. Number of issued capital of Ram Ltd. is 1 lakh. Fair value of identifiable assets of Ram Ltd. is ₹ 640 lakh and that of liabilities is ₹ 50 lakh. As on the date of acquisition, market price per share of Ram Ltd. is ₹ 775. Find out the value of goodwill.

Solution

	(₹ in lakh)
(i) Fair value of consideration paid	525
(ii) Fair value of non-controlling interest (40% x 1 lakh x ₹ 775)	310
(A)	835
Fair value of identified assets	640
Less: Fair value of liabilities	(50)
Fair value of Net Identified Assets (B)	590
Goodwill [(A) – (B)]	**245**

Note: When goodwill is measured taking non-controlling interest at fair value, it is often termed as full goodwill.

On the other hand, it is possible to measure non-controlling at the proportionate value of net assets.

	Amount in lakhs
(i) Fair value of consideration paid	525
(ii) Proportionate value of non-controlling interest (40% x 590 lakh)	236
(A)	761
Fair value of identified assets	640
Minus fair value of liabilities	(50)
Fair value of Net assets (B)	590
Goodwill [(A)-(B)]	171

When non-controlling interest is measured at proportionate share of net asset, the goodwill is popularly termed as partial goodwill.

5.3.3 Acquisition of interest in subsidiaries at different dates

1. An investor sometimes obtains control of a subsidiary in which it held an equity interest immediately before the acquisition date.

Example

On 31 December 20X1, Entity A holds a 35% non-controlling equity interest in Entity B. On that date, Entity A purchases an additional 40% interest in Entity B, which gives it control of Entity B.

Ind AS refers to such a transaction as a business combination achieved in stages, sometimes also referred to as a step acquisition.

2. In a business combination achieved in stages, the investor (parent) shall re-measure its previously held equity interest in the investee (now subsidiary) at its acquisition-date fair value and recognize the resulting gain or loss, if any, in profit or loss or other comprehensive income, as appropriate.

3. In prior reporting periods, the investor (parent) may have recognized changes in the value of its equity interest in the investee in other comprehensive income. If so, the amount that was recognized in other comprehensive income shall be recognized on the same basis as would be required if the investee (parent) had disposed directly of the previously held equity interest.

Illustration 6: Step acquisition when control is obtained.

Entity D has a 40% interest in entity E. The carrying value of the equity interest, which has been accounted for as an associate in accordance with Ind AS 28 is ₹ 40 lakh. Entity D purchases the remaining 60% interest in entity E for ₹ 600 lakh in cash. The fair value of the 40% previously held equity interest is determined to be ₹ 400 lakh, the net aggregate value of the identifiable assets and liabilities measured in accordance with Ind AS 103 is determined to be identifiable ₹ 880 lakh. The tax consequences have been ignored. How does entity D account for the business combination?

Solution

Entity D recognizes at the acquisition date:

i. 100% of the identifiable net assets

ii. Goodwill as the excess of 1 over 2 below:

1. The aggregate of:
   - Consideration transferred
   - The amount of any non-controlling interest (Not applicable in this example)
   - In a business combination achieved in stages, the acquisition date fair value of the acquirer's previously held equity interest in the acquire.
2. The assets and the liabilities recognized in accordance with Ind AS 103.

The journal entry recorded on the date of acquisition of the 60% controlling interest is as follows:

		Dr. (₹ in lakh)	Cr. (₹ in lakh)
Identifiable net assets	Dr.	880	
Goodwill	Dr.	120	
To Cash			600
To Associate interest			40
To Gain on equity interest			360

Goodwill is calculated as follows:

	₹ in lakh
Fair value of consideration transferred	600
Fair value of previously held equity interest	400
	1,000
Less: Recognised value of 100% of the identifiable net assets, measured in accordance with the standards	(880)
Goodwill	120

The gain on the 40% previously held equity interest is recognized in the income statement. The fair value of the previously held equity interest less the carrying value of the previously held equity interest is ₹ 360 lakh (400 – 40).

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5.3.4 Acquisition of interest in subsidiaries without consideration

1. An entity (say entity A) sometimes obtains control of another entity (say entity B) without transferring consideration. Such circumstances include:

   - That another entity (entity B) repurchases a sufficient number of its own shares for an existing investor (entity A) to obtain control;
   - Minority veto rights lapse that previously kept the investor (entity A) from controlling that another entity (entity B) in which the investor (entity a) held the majority voting rights.
   - The investor (entity A) and investee (entity B) agree to combine their businesses by contract alone. The investor (entity A) transfers no consideration in exchange for control of the investee (entity B) and holds no equity interests in the investee, either on the acquisition date or previously. Examples of business combinations achieved by contract alone include bringing two businesses together in a stapling arrangement or forming a dual listed corporation.

2. In a business combination achieved by contract alone, the investor (entity A) shall attribute to the owners of the investee (entity B) the amount of the investee's (entity B) net assets recognized in accordance with Ind AS 103. In other words, the equity interests in the investee (entity B) held by parties other than the investor (entity A) are a non-controlling interest in the investor's (entity A) post-combination financial statements even if the result is that all of the equity interests in the investor (entity A) are attributed to the non-controlling interest.

5.4 UNIFORM ACCOUNTING POLICIES

A parent shall prepare consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances.

If a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to that group member's financial statements in preparing the consolidated financial statements to ensure conformity with the group's accounting policies.

Illustration 7

PQR Ltd. is the subsidiary company of MNC Ltd. In the individual financial statements prepared in accordance with Ind AS, PQR Ltd. has adopted Straight-line method (SLM) of depreciation and MNC Ltd. has adopted Written-down value method (WDV) for depreciating its property, plant and equipment. As per Ind AS 110, Consolidated Financial Statements, a parent shall prepare consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances.

How will these property, plant and equipment be depreciated in the consolidated financial statements of MNC Ltd. prepared as per Ind AS?

Solution

As per paragraph 60 and 61 of Ind AS 16, 'Property, Plant and Equipment', a change in the method of depreciation shall be accounted for as a change in an accounting estimate as per Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors'.

Therefore, the selection of the method of depreciation is an accounting estimate and not an accounting policy.

The entity should select the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. That method should be applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits in separate financial statements as well as consolidated financial statements.

Therefore, there can be different methods of estimating depreciation for property, plant and equipment, if their expected pattern of consumption is different. The method once selected in the individual financial statements of the subsidiary should not be changed while preparing the consolidated financial statements.

Accordingly, in the given case, the property, plant and equipment of PQR Ltd. (subsidiary company) may be depreciated using straight line method and property, plant and equipment of parent company (MNC Ltd.) may be depreciated using written down value method, if such method closely reflects the expected pattern of consumption of future economic benefits embodied in the respective assets.

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Illustration 8

H Limited has a subsidiary, S Limited and an associate, A Limited. The three companies are engaged in different lines of business.

These companies are using the following cost formulas for their valuation in accordance with Ind AS 2, Inventories:

Name of the Company	*Cost formula used*
H Limited	*FIFO*
S Limited, A Limited	*Weighted average cost*

Whether H Limited is required to value inventories of S Limited and A Limited also using FIFO formula in preparing its consolidated financial statements?

Solution

Paragraph 19 of Ind AS 110 states that a parent shall prepare consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances.

Paragraph B87 of Ind AS 110 states that if a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to that group member's financial statements in preparing the consolidated financial statements to ensure conformity with the group's accounting policies.

It may be noted that the above mentioned paragraphs requires an entity to apply uniform accounting policies "for like transactions and events in similar circumstances". If any member of the group follows a different accounting policy for like transactions and events in similar circumstances, appropriate adjustments are to be made in preparing consolidated financial statements.

Paragraph 5 of Ind AS 8 defines accounting policies as "the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements."

Ind AS 2 requires inventories to be measured at the lower of cost and net realisable value.

Paragraph 25 of Ind AS 2 states that the cost *of* inventories shall be assigned by using FIFO or weighted average cost formula. An entity shall use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formulas may be justified.

Elaborating on the requirements of paragraph 25, paragraph 26 of Ind AS 2 illustrates that inventories used in one operating segment may have a use to the entity different from the same type of inventories used in another operating segment. However, a difference in geographical location of inventories (or in the respective tax rules), by itself, is not sufficient to justify the use of different cost formulas.

Paragraph 36(a) of Ind AS 2 requires disclosure of "the accounting policies adopted in measuring inventories, including the cost formula used". Thus, as per Ind AS 2, the cost formula applied in valuing inventories is also an accounting policy.

As mentioned earlier, as per Ind AS 2, different cost formulas may be justified for inventories of a different nature or use. Thus, if inventories of S Limited and A Limited differ in nature or use from inventories of H Limited, then use of cost formula (weighted average cost) different from that applied in respect of inventories of H Limited (FIFO) in consolidated financial statements may be justified. In other words, in such a case, no adjustment needs to be made to align the cost formula applied by S Limited and A Limited to cost formula applied by H Limited.

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5.5 MEASUREMENT

5.5.1 Profit or loss of subsidiary companies

An entity includes the income and expenses of a subsidiary in the consolidated financial statements from the date it gains control until the date when the entity ceases to control the subsidiary. Income and expenses of the subsidiary are based on the amounts of the assets and liabilities recognized in the consolidated financial statements at the acquisition date.

An entity shall attribute the profit or loss and each component of other comprehensive income to the owners of the parent and to the non-controlling interests. The entity shall also attribute total comprehensive income to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance.

Illustration 9

A Ltd. acquired 70% of equity shares of B Ltd. on 1.04.20X1 at cost of ₹ 10,00,000 when B Ltd. had an equity share capital of ₹ 10,00,000 and other equity of ₹ 80,000. In the four consecutive years B Ltd. fared badly and suffered losses of ₹ 2,50,000, ₹ 4,00,000, ₹ 5,00,000 and ₹ 1,20,000 respectively. Thereafter in 20X5 - 20X6, B Ltd. experienced turnaround and registered an annual profit of ₹ 50,000. In the next two years i.e. 20X6-20X7 and 20X7-20X8, B Ltd. recorded annual profits of ₹ 1,00,000 and ₹ 1,50,000 respectively. Show the non- controlling interests and goodwill at the end of each year for the purpose of consolidation.

Assume that the assets are at fair value.

Solution

Year	Profit/loss	Non-controlling Interest (30%)	Additional Consolidated P & L (Dr.) Cr.	NCI's share of losses borne by A Ltd.		Goodwill
				₹	Balance	
At the time of		3,24,000 (W.N.)				

acquisition in 20X1						
20X1-20X2	(2,50,000)	(75,000)	(1,75,000)			2,44,000 (W.N.)
		2,49,000				
20X2-20X3	(4,00,000)	(1,20,000)	(2,80,000)			2,44,000
		1,29,000				
20X3-20X4	(5,00,000)	(1,50,000)	(3,50,000)			2,44,000
		(21,000)				
20X4-20X5	(1,20,000)	(36,000)	(84,000)			2,44,000
		(57,000)				
20X5-20X6	50,000	15,000	35,000			2,44,000
		(42,000)				
20X6-20X7	1,00,000	30,000	70,000			2,44,000
		(12,000)				
20X7-20X8	1,50,000	45,000	1,05,000			2,44,000
		33,000				

Working Note:

Calculation of Non-controlling interest:	**₹**
Share Capital	10,00,000
Other equity	80,000
Total	10,80,000
NCI (30% x 10,80,000)	3,24,000

NCI is measured at NCI's proportionate share of the acquiree's identifiable net assets. (Considering the carrying amount of share capital & other equity to be fair value).

Calculation of Goodwill:	**₹**
Consideration	10,00,000
Non-controlling interest	3,24,000
Less: Net Assets	(10,80,000)
Goodwill	2,44,000

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5.5.2 Potential Voting Rights

When potential voting rights, or other derivatives containing potential voting rights, exist, the proportion of profit or loss and changes in equity allocated to the parent and non - controlling interests in preparing consolidated financial statements is determined solely on the basis of existing ownership interests and does not reflect the possible exercise or conversion of potential voting rights and other derivatives, unless the below mentioned provision applies.

In some circumstances an entity has, in substance, an existing ownership interest as a result of a transaction that currently gives the entity access to the returns associated with an ownership interest. In such circumstances, the proportion allocated to the parent and non-controlling interests in preparing consolidated financial statements is determined by taking into account the eventual exercise of those potential voting rights and other derivatives that currently give the entity access to the returns.

Ind AS 109 does not apply to interests in subsidiaries that are consolidated. When instruments containing potential voting rights in substance currently give access to the returns associated with an ownership interest in a subsidiary, the instruments are not subject to the requirements of Ind AS 109. In all other cases, instruments containing potential voting rights in a subsidiary are accounted for in accordance with Ind AS 109.

5.5.3 Dividend received from subsidiary companies

As per para 5.7.1A of Ind AS 109, dividends are recognized in profit or loss by an investor entity only when:

- The entity's right to receive payment of the dividend is established;
- It is probable that the economic benefits associated with the dividend will flow to the entity; and
- the amount of the dividend can be measured reliably.

As per para 12 of Ind AS 27, an entity shall recognize a dividend from a subsidiary in its separate financial statements when its right to receive the dividend is established.

As per the Companies Act, 2013, the entity's right to receive the dividend is established when it is declared by the shareholders in the annual general meeting of the Company.

An investor should recognise a dividend from a subsidiary, a joint venture or an associate as income in its separate financial statements. However, it may lead to investments in subsidiaries, joint ventures and associates being overstated in the separate financial statements. Therefore, in such a situation, Ind AS 36 states that such investment should be tested for impairment.

Illustration 10

XYZ Ltd. purchased 80% shares of ABC Ltd. on 1st April, 20X1 for ₹ 1,40,000. The issued capital of ABC Ltd., on 1st April, 20X1 was ₹ 1,00,000 and the balance in the Statement of Profit and Loss was ₹ 60,000.

For the year ending on 31st March, 20X2 ABC Ltd. has earned a profit of ₹ 20,000 and later on, it declared and paid a dividend of ₹ 30,000.

Assume, the fair value of non-controlling interest is same as the fair value on a per-share basis of the purchased interest. All net assets are identifiable net assets, there are no non-identifiable assets. The fair value of identifiable net assets is ₹ 1,50,000.*

Show by an entry how the dividend should be recorded in the books of XYZ Ltd. whenever it is received after approval in the ensuing annual general meeting.

What is the amount of non-controlling interest as on 1st April, 20X1 (using Fair Value Method) and 31st March, 20X2. Also pass a journal entry on the acquisition date.

Solution

XYZ Ltd.'s share of dividend = ₹ 30,000 x 80% = ₹ 24,000

		₹	₹
Bank A/c	Dr.	24,000	
To Profit & Loss A/c			24,000

Calculation of Non- controlling interest and Journal Entry

NCI on 1st April 20X1 = 20% of Fair value on a per-share basis of the purchased interest.

= 20% x ₹ 1,75,000 (W.N 1) = ₹ 35,000

The journal entry recorded on the acquisition date for the 80% interest acquired is as follows:

		₹	₹
Identifiable net assets	Dr.	1,50,000	
Goodwill (Balancing Figure)	Dr.	25,000	
To Cash			1,40,000
To NCI			35,000

Working Note 1

Fair value on a per-share basis of the purchased interest / Fair Value of Identifiable net assets

= Consideration transferred x 100/80

= 1,40,000 x 100/80 = ₹ 1,75,000

NCI on 31st March 20X2 = NCI on 31st March 20X1 + Share of NCI in Profits of 20X1- 20X2

= 35,000 + (20,000 x 20%) = ₹ 39,000

Note: Dividend as per Ind AS will be recognized only when approval by the shareholder is received in the annual general meeting.

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∗This assumption is only for illustration purpose. However, in the practical scenarios, the fair value of NCI will be lower than the fair value of CI (Controlling Interest) since the consideration paid for acquiring controlling interest will include control premium.

Illustration 11

From the facts given in the above illustration, calculate the amount of non-controlling interest as on 1st April, 20X1 (Using NCI's proportionate share method) and 31st March, 20X2.

Also pass a journal entry on the acquisition date.

Solution

NCI on 1st April 20X1 = 20% of Fair value of Identifiable net assets

= 20% x ₹ 1,50,000 = ₹ 30,000

The journal entry recorded on the acquisition date for the 80% interest acquired is as follows:

		₹	₹
Identifiable net assets	Dr.	1,50,000	
Goodwill (Balancing Figure)	Dr.	20,000	
To Cash			1,40,000
To NCI			30,000

NCI on 31st March 20X2 = NCI on 31st March 20X1 + Share of NCI in Profits of 20X1-20X2

= 30,000 + (20,000 x 20%)

= ₹ 34,000

Note: Dividend as per Ind AS will be recognized only when approval by the shareholder is received.

Illustration 12

The facts are same as in the above illustration except that the fair value of net identifiable assets is ₹ 1,60,000. Calculate NCI and Pass Journal Entry on the acquisition date.

Note: Use fair value method for 31st March 20X1.

Solution

Calculation of Non- controlling interest and Journal entry

NCI on 1st April 20X1 = 20% of Fair value on a per-share basis of the purchased interest.

= 20% X ₹ 1,75,000 (WN 1) = ₹ 35,000

The journal entry recorded on the acquisition date for the 80% interest acquired is as follows:

		₹	₹
Identifiable net assets	Dr.	1,60,000	
Goodwill (Balancing Figure)	Dr.	15,000	
To Cash			1,40,000
To NCI			35,000

Working Note 1:

Fair value on a per-share basis of the purchased = Consideration transferred x 100/80 interest/ Fair Value of Identifiable net assets = 1,40,000 x 100/80 = ₹1,75,000

NCI on 31st March 20X2 = NCI on 31st March 20X1 + Share of NCI in Profits of 20X1-20X2

= ₹ 35,000 + 20,000 X 20% = 39,000

* Dividend as per Ind AS will be recognized only when approval by the shareholder is received.

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Illustration 13

The facts are same as in the above illustration except that the fair value of net identifiable assets is ₹ 1,60,000. Calculate NCI and Pass Journal Entry on the acquisition date. Use NCI's proportionate share method for 31st March 20X1.

Solution

NCI on 1st April 20X1 = 20% of Fair value of Identifiable net assets

= 20% x ₹ 1,60,000 = ₹ 32,000

The journal entry recorded on the acquisition date for the 80% interest acquired is as follows:

		₹	₹
Identifiable net assets	Dr.	1,60,000	
Goodwill (Balancing Figure)	Dr.	12,000	
To Cash			1,40,000
To NCI			32,000

NCI on 31st March 20X2 = NCI on 31st March 20X1 + Share of NCI in Profits of 20X1-20X2

= 32,000 + (20,000 X 20%) = ₹ 36,000

* Dividend as per Ind AS will be recognized only when approval by the shareholder is received.

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Illustration 14

From the following data, determine in each case:

(1) Non-controlling interest at the date of acquisition (using proportionate share method) and at the date of consolidation

(2) Goodwill or Gain on bargain purchase.

(3) Amount of holding company's profit in the consolidated Balance Sheet assuming holding company's own retained earnings to be ₹ 2,00,000 in each case

Case	Subsidiary company	% of shares owned	Cost	Date of Acquisition 1.04.20X1		Consolidation date 31.03.20X2	
				Share Capital [A]	Retained earnings [B]	Share Capital [C]	Retained earnings [D]
Case 1	A	90%	1,40,000	1,00,000	50,000	1,00,000	70,000

Case 2	*B*	*85%*	*1,04,000*	*1,00,000*	*30,000*	*1,00,000*	*20,000*
Case 3	*C*	*80%*	*56,000*	*50,000*	*20,000*	*50,000*	*20,000*
Case 4	*D*	*100%*	*1,00,000*	*50,000*	*40,000*	*50,000*	*56,000*

The company has adopted an accounting policy to measure Non-controlling interest at NCI's proportionate share of the acquiree's identifiable net assets.

Solution

(1) Non-controlling Interest = the equity in a subsidiary not attributable, directly or indirectly, to a parent. Equity is the residual interest in the assets of an entity after deducting all its liabilities i.e. in this given case Share Capital + Statement of Profit & Loss (Assuming it to be the net aggregate value of identifiable assets in accordance with Ind AS)

	% Shares Owned by NCI [E]	Non-controlling interest as at the date of acquisition [E] x [A + B]	Non-controlling interest as at the date of consolidation [E] X [C + D]
Case 1 [100 - 90]	10%	15,000	17,000
Case 2 [100 - 85]	15%	19,500	18,000
Case 3 [100 - 80]	20%	14,000	14,000
Case 4 [100 - 100]	Nil	Nil	Nil

(2) Calculation of Goodwill or Gain on bargain purchase

	Consideration [G]	Non-controlling interest [H]	Net Identifiable assets [A] + [B] = [I]	Goodwill [G] + [H] – [I]	Gain on bargain Purchase [I] – [G] – [H]
Case 1	1,40,000	15,000	1,50,000	5,000	-
Case 2	1,04,000	19,500	1,30,000	-	6,500
Case 3	56,000	14,000	70,000	Nil	Nil
Case 4	1,00,000	0	90,000	10,000	-

(3) The balance in the Statement of Profit & Loss on the date of acquisition (1.04.20X1) is acquisition date profit, as such the balance of Consolidated Profit & Loss Account shall be equal to Holding Co.'s Profit.

On 31.03.20X2 in each case the following amount shall be added or deducted from the balance of holding Co.'s Retained earnings.

	% Share Holding [K]	Retained earnings as on 31.03.20X1 [L]	Retained earnings as on consolidation Date [M]	Retained earnings post-acquisition [N] = [M] – [L]	Amount to be added/(deducted) from holding's Retained earnings [O] = [K] x [N]
1	90%	50,000	70,000	20,000	18,000
2	85%	30,000	20,000	(10,000)	(8,500)
3	80%	20,000	20,000	Nil	Nil
4	100%	40,000	56,000	16,000	16,000

*****

5.5.4 Preparation of consolidated balance sheet

- When preparing the consolidated balance sheet, assets and outside liabilities of the subsidiary company are merged with those of the holding company. Equity share capital and other equity of the subsidiary company are apportioned between holding company and non–controlling interests (erstwhile minority shareholders as per AS 21). These items, along with investments of holding company in shares of subsidiary company are not separately shown in consolidated balance sheet. The net amounts resulting from various computations on these items, shown as (a) non - controlling interest (b) goodwill / capital reserve (c) holding company's share in post-acquisition profits of the subsidiary company (added to appropriate concerned account of the holding company) are entered in consolidated balance sheet. The method of calculation of these items with detailed treatment of other relevant issues has been dealt with in various places in this unit separately.
- As per Ind AS 110, if an entity makes two or more investments in another entity at different dates and eventually obtain control of the other entity the consolidated financial statements are presented only from the date on which holding-subsidiary relationship comes in existence.
- As per Ind AS 103, goodwill is computed only once when control is obtained. Any previously held interests in the acquiree is fair valued and aggregated with consideration for computation of goodwill / bargain purchase gain.

5.5.5 Elimination of intra – group transactions

In order to present financial statements for the group in a consolidated format, the effect of transactions between group entities should be eliminated. Para B86 of Ind AS 110 states that intra - group balances and intra - group transactions and resulting unrealized profits should be eliminated in full. Unrealized losses resulting from intra - group transactions should also be eliminated unless cost cannot be recovered.

Liabilities due to one group entity by another will be set off against the corresponding asset in the other group entity's financial statements; sales made by one group entity to another should be excluded from turnover and from purchase (or related head) or the appropriate expense heading in the consolidated statement of profit and loss.

To the extent that the buying entity has further sold the goods in question to a third party, the eliminations to sales and cost of sales are all that is required, and no adjustments to consolidated profit or loss for the period, or to net assets, are needed. However, to the extent that the goods in question are still on hand at year end, they may be carried at an amount that is in excess of cost to the group and the amount of the intra-group profit must be eliminated, and assets are reduced to cost to the group.

For transactions between group entities, unrealized profits resulting from intra-group transactions that are included in the carrying amount of assets, such as inventories and Property, Plant and Equipment, Intangible Assets and Investment Property, are eliminated in full. The requirement to eliminate such profits in full applies to the transactions of all subsidiaries that are consolidated – even those in which the group's interest is less than 100%.

5.5.5.1 Unrealised profit in inventories:

Where a group entity sells goods to another, the selling entity, as a separate legal entity, records profits made on those sales. If these goods are still held in inventory by the buying entity at the year end, however, the profit recorded by the selling entity, when viewed from the standpoint of the group as a whole, has not yet been earned, and will not be earned until the goods are eventually sold outside the group. On consolidation, the unrealized profit on closing inventories will be eliminated from the group's profit, and the closing inventories of the group will be recorded at cost to the group.

5.5.5.2 Unrealised profit on transfer of non-current asset:

Similar to the treatment described above for unrealized profits in inventories, unrealized inter-company profits arising from intra-group transfers of Property, Plant and Equipment, Intangible Assets and Investment Property are also eliminated from the consolidated financial statements.

5.5.5.3 Unrealised losses:

Unrealised losses resulting from intra-group transactions that are deducted in arriving at the carrying amount of assets are also eliminated **unless cost cannot be recovered.**

Illustration 15: Elimination of intra-group profit on sale of assets by a subsidiary to its parent

A parent owns 60% of a subsidiary. The subsidiary sells some inventory to the parent for ₹ 35,000 and makes a profit of ₹ 15,000 on the sale. The inventory is in the parent's balance sheet at the year end. Examine the treatment of intra-group transaction and pass the necessary journal entry.

Solution

The parent must eliminate 100% of the unrealized profit on consolidation. The inventory will, therefore, be carried in the group's balance sheet at ₹ 20,000 (₹ 35,000 - ₹ 15,000). The consolidated income statement will show a corresponding reduction in profit of ₹ 15,000.

The double entry on consolidation is as follows:

		₹ '000	₹'000
Consolidated Revenue	Dr	35	

To Cost of sales	20
To Inventory	15

The reduction of group profit of ₹ 15,000 is allocated between the parent company and non-controlling interest in the ratio of their interests – 60% and 40%.

*****

Illustration 16: Elimination of intra-group profit on sale of assets by a parent to its subsidiary

In the above illustration, assume that it is the parent that makes the sale. The parent owns 60% of a subsidiary. The parent sells some inventory to the subsidiary for ₹ 35,000 and makes a profit of ₹ 15,000. On the sale the inventory is in the subsidiary's balance sheet at the year end. Examine the treatment of intra-group transaction and pass the necessary journal entry.

Solution

The parent must eliminate 100% of the unrealized profit on consolidation. The inventory will, therefore, be carried in the group's balance sheet at ₹ 20,000. (₹ 35,000 – ₹ 15,000). The consolidated income statement will show a corresponding reduction in profit of ₹ 15,000.

The double entry on consolidation is follows:

		₹'000	₹'000
Consolidated Revenue A/c	Dr	35	
To Cost of sales A/c			20
To Inventory A/c			15

In this case, since it is the parent that has made the sale, the reduction in profit of ₹15,000 is allocated entirely to the parent company.

*****

Illustration 17: Inventories of subsidiary out of purchases from the parent

A Ltd, a parent company sold goods costing ₹ 200 lakh to its 80% subsidiary B Ltd. at ₹ 240 lakh. 50% of these goods are lying at its stock. B Ltd. has measured this inventory at cost i.e. at ₹ 240 lakh. Show the necessary adjustment in the consolidated financial statements (CFS). Assume 30% tax rate.

Solution

A Ltd., shall reduce the inventories of ₹ 120 lakh of B Ltd., by ₹ 20 lakh in CFS. This will increase expenses and reduce consolidated profit by ₹ 20 lakh. It shall also create deferred tax asset of ₹ 6 lakh since accounting base of inventories (₹ 100 lakh) is lower than its tax base (₹ 120 lakh).

*****

Illustration 18: Inventories of the parent out of purchase from subsidiary

Ram Ltd., a parent company purchased goods costing ₹ 100 lakh from its 80% subsidiary Shyam Ltd. at ₹ 120 lakh. 50% of these goods are lying at the godown. Ram Ltd. has measured this inventory at cost i.e. at ₹ 60 lakh. Show the necessary adjustment in the consolidated financial statements (CFS). Assume 30% tax rate.

Solution

Ram Ltd., shall reduce the inventories of ₹ 60 lakh of Shyam Ltd., by ₹ 10 lakh in CFS This will increase expenses and reduce consolidated profit by ₹ 10 lakh. It shall also create deferred tax asset of ₹ 3 lakh since accounting base of inventories (₹ 50lakh) is lower than its tax base (₹ 60 lakh).

*****

5.5.6 Preparation of consolidated profit & loss

For preparation of Consolidated Profit and Loss Account of holding company and its subsidiaries, the revenue items are to be added on line by line basis and from the consolidated revenue items inter-company transactions should be eliminated. For example, a holding company may sell goods or services to its subsidiary, receives consultancy fees, commission, royalty etc. These items are included in sales and other income of the holding company and in the expense items of the subsidiary. Alternatively, the subsidiary may also sell goods or services to the holding company. These inter-company transactions are to be eliminated in full.

If there remains any unrealized profit in the inventory of good, of any of the group company, such unrealized profit is to be eliminated from the value of inventory to arrive at the consolidated profit.

However, preparation of Consolidated Profit and Loss Account can prove to be a challenge when the fair value of net assets acquired at the acquisition date were different from the carrying amount specified in subsidiary's books. In such a case, the income and expense should be with reference to those fair values plus the values reported by the subsidiary and not simply the values reported by the subsidiary

5.5.7 Preparation of consolidated cash flows

Same as consolidated Statement of Profit and Loss, the preparation of consolidated cash flow statement is also not difficult. All the items of cash flow from operating activities and financing activities are to be added on line by line basis and from the consolidated items, inter – company transactions should be eliminated.

Illustration 19

Given below are the financial statements of P Ltd and Q Ltd as on 31.3.20X1:

Balance Sheets *(₹ in lakhs)*

	P Ltd.	*Q Ltd.*
Assets		
Non-current Assets		
Property Plant Equipment	*1,07,000*	*44,000*
Financial Assets:		
Non-Current Investments	*5,000*	*1,000*
Loans	*10,000*	

Current Assets		
Inventories	20,000	10,000
Financial Assets:		
Trade Receivables	8,000	10,000
Cash and Cash Equivalents	38,000	1,000
Total Assets	1,88,000	66,000
Equity and Liabilities		
Shareholders Fund		
Share Capital	20,000	10,000
Other equity	1,20,000	40,000
Non-current Liabilities		
Financial liabilities:		
Long term liabilities	30,000	10,000
Deferred tax liabilities	5,000	1,000
Long term provisions	5,000	1,000
Current Liabilities		
Financial liabilities:		
Trade Payables	6,000	2,000
Short term Provisions	2,000	2,000
Total Equity & Liabilities	1,88,000	66,000
Notes to Financial Statements	***P Ltd***	***Q Ltd***
Reserve & Surplus		
General Reserve	1,00,000	30,000
Retained earnings	20,000	10,000
	1,20,000	40,000
Inventories		
Raw Material	10,000	5,000
Finished Goods	10,000	5,000
	20,000	10,000

(₹ in lakhs)

Statement of Profit and Loss For the year ended on 31 March, 20X2			
	Notes	P Ltd	Q Ltd
I. Statement of Profit and Loss for the year ended on 31 March 20X2			
Sales	1	2,00,000	80,000
Other Income	2	3,000	
Total Revenue		2,03,000	80,000
Expenses			
Raw Material Consumed	3	1,10,000	48,000
Change in inventories finished stock	4	(5,000)	(3,000)
Employee benefit expenses		30,000	10,000
Finance Costs	5	2,700	1,000
Depreciation		7,000	4,000
Other Expenses	6	10,350	6,040
Total expenses		1,55,050	66,040
Profit Before Tax		47,950	13,960
Tax Expense:			
Current Tax	11	15,000	4,000
Deferred Tax		2,000	1,000
		17,000	5,000
Profit After Tax		30,950	8,960
II. Statement of Other Comprehensive Income			
Fair value gain on investment in subsidiary	8	1,000	0
Fair value gain on other non-current investments*	8	500	250
		1,500	250

***Note:** Statement of Other Comprehensive Income shall present 'Items that will not be reclassified to profit or loss' and 'Items that will be reclassified to profit and loss'. However, such bifurcations had not been made above.

Statement of changes in Equity
For the year ended on 31 March 20X2

P Ltd.	Share Capital	General Reserve	Profit & Loss	Fair Value Reserve	Total
Balance as on 1.4.20X1	20,000	1,00,000	20,000		1,40,000
Dividend for the year 20X1-20X2			(8,000)		(8,000)
Dividend distribution tax			(1,350)		(1,350)
Dividend received from subsidiary			1,680		1,680
Profit for the year 20X1-20X2			30,950		30,950
Fair value gain on investment in subsidiary See Note 7				1,000	1,000
Fair value gain on other non-current investments see note 7				500	500
Transfer to reserve	____	20,000	(20,000)	____	____
Balance as on 31.3.20X2	**20,000**	**1,20,000**	**23,280**	**1,500**	**1,64,780**
Q Ltd					
Balance as on 1.4.20X1	10,000	30,000	10,000		50,000
Dividend for the year 20X1-20X2			(2,400)		(2,400)
Dividend distribution tax			(400)		(400)
Profit for the year 20X1-20X2			8,960		8,960
Fair value gain on other non-current investments see note 7				250	250
Transfer to reserve	____	5,000	(5,000)	____	____
Balance as on 31.3.20X2	**10,000**	**35,000**	**11,160**	**250**	**56,410**

Balance Sheet as on 31 March, 20X2	Note	P Ltd	Q Ltd
Assets			
Non-current Assets			
Fixed Assets			
Property Plant Equipment	7	1,17,000	45,000
Financial Assets:			
Non-Current Investments	8	40,820	1,250
Long term loans		10,000	
Current Assets			
Inventories		35,000	15,000

Financial Assets:			
Trade Receivables		10,000	8,000
Cash and Cash Equivalents			
(See Statement of cash flows)		930	4,200
		45,930	27,200
Total Assets		**2,13,750**	**73,450**
Equity and Liabilities			
Share Capital		20,000	10,000
Other Equity (See Statement of changes in Equity)		1,43,100	46,410
		1,63,100	56,410
Non-current Liabilities			
Financial Liabilities:			
Borrowings		30,000	10,000
Deferred tax liabilities		7,000	2,000
Long term provisions	9	4,600	930
		41,600	12,930
Current Liabilities			
Financial Liabilities:			
Trade Payables		8,000	4,000
Short term Provisions	10	1,050	110
		9,050	4,110
Total Liabilities		**50,650**	**17,040**
Total Equity & Liabilities		**2,13,750**	**73,450**

Statement of Cash Flows
For the year ended on 31 March 20X2

	P Ltd	Q Ltd
I. Cash flows from operating activities		
Profit after Tax	30,950	8,960
Add Back:		
Current Tax	15,000	4,000
Deferred Tax	2,000	1,000
Depreciation	7,000	4,000
Finance Costs	2,700	1,000
Change in Provisions	(1,350)	(1,960)
Reversal of Interest Income	(1,000)	0
Working capital adjustments		

Inventories	(15,000)	(5,000)
Trade Receivables	(2,000)	2,000
Trade Payables	2,000	2,000
	40,300	16,000
Less: Advance Tax	(15,000)	(4,000)
	25,300	12,000
II. Cash flows from investment activities		
Purchase of Property Plant Equipment	(17,000)	(5,000)
Acquisition of subsidiary	(36,000)	0
Interest Income	1,000	
Dividend Income	1,680	
	(50,320)	(5,000)
III. Cash flow from financing activities		
Dividend Payment	(8,000)	(2,400)
Dividend distribution tax	(1,350)	(400)
Interest payment	(2,700)	(1,000)
	(12,050)	(3,800)
Net Changes in Cash Flows (I+II+III)	**(37,070)**	**3,200**
Balance of Cash and Cash Equivalents as on 1.4.20X1	38,000	1,000
Balance of Cash and Cash Equivalents as on 31.3.20X2	930	4,200
Notes	**P Ltd.**	**Q Ltd.**
Note 1- Sales		
Sales to Q Ltd.	20,000	
Other Sales	1,80,000	80,000
	2,00,000	**80,000**
Note 2- Other Income		
Interest from Q Ltd	1,000	
Royalty from Q Ltd	2,000	
	3,000	
Note 3- Raw Material Consumed		
Opening Stock	10,000	5,000
Purchases from P Ltd		20,000
Other Purchases	1,20,000	30,000
Closing Stock	20,000	7,000
	1,10,000	**48,000**

Note 4- Change in inventories of finished stock		
Opening Stock	10,000	5,000
Closing Stock	15,000	8,000
	(5,000)	**(3,000)**
Note 5- Finance costs		
Interest	2,700	
Interest to P Ltd		1,000
	2,700	**1,000**
Note 6- Other Expenses		
Long term provisions	100	30
Short term provisions	50	10
Royalty to P Ltd		2,000
Others	10,000	4,000
Acquisition Expenses	200	
	10,350	**6,040**
Note 7- Property Plant Equipment		
New Purchases	**17,000**	**5,000**
Note 8- Fair value of non-current investments		
Investments in subsidiary	37,000	
Other Investments	5,500	1,250
	42,500	**1,250**
Fair value gain		
Investments in subsidiary	1,000	0
Other investments	500	250
	1,500	**250**
Note 9- Long term provisions		
Balance as on 1.4.20X1	5,000	1,000
Transfer to short term provisions	(500)	(100)
New Provision	100	30
Balance as on 31.3.20X2	**4,600**	**930**
Note 10- Short term provisions		
Balance as on 1.4.20X1	2,000	2,000
Transfer from long term provisions	500	100
Payment	(1,500)	(2,000)
New	50	10
Balance as on 31.3.20X2	**1,050**	**110**

Note 11- Provision for Tax & Advance Tax		
Tax Provision	*15,000*	*4,000*
Less: Advance Tax	*15,000*	*4,000*
	0	*0*

On 1.4.20X1, P Ltd acquired 70% of equity shares (700 lakhs out of 1000 lakhs shares) of Q Ltd. at ₹ 36,000 lakhs. The company has adopted an accounting policy to measure Non-controlling interest at fair value (quoted market price) applying Ind AS 103. Accordingly, the company computed full goodwill on the date of acquisition. Shares of both the companies are of face value ₹ 10 each. Market price per share of Q Ltd. as on 1.4.20X1 is ₹ 55. Entire long term borrowings of Q Ltd. is from P Ltd. The fair value of net identifiable assets is at ₹ 50,000 lakhs.

P Ltd has decided to account for investment in subsidiary at fair value as per Ind AS 27. Other non-current investments are classified as financial assets at fair value through profit and loss by irrevocable choice as per Ind AS 109. There is no tax on long term capital gains.

The group has paid dividend for the year 20X0-20X1 and transferred to reserve out of profit for 20X1-20X2 as follows: *(₹ in lakhs)*

	P Ltd	***Q Ltd***		
Dividend for the year 20X0-20X1		***Share of P Ltd.***	***Non-Controlling interest***	***Total***
Dividend	*8,000*	*1,680*	*720*	*2,400*
Dividend distribution tax	*1,350*	*280*	*120*	*400*
	9,350	*1,960*	*840*	*2,800*
Transfer to Reserve out of profit for the year 20X1-20X2	*20,000*			

Trade Receivables of P Ltd, includes ₹ 3,000 lakhs due from Q Ltd.

Based on the above financial statements for the year ended on 31 March, 20X2 and information given, prepare Consolidated Financial Statements.

Solution

Consolidated Financial Statements of P Ltd. Group **(₹ In lakhs)**

Consolidated Statement of Comprehensive Income For the year ended on 31 March, 20X2					
I. Statement of Profit and loss	**Notes**	**P Ltd**	**Q Ltd**	**Workings**	**Group**
Sales	1	2,00,000	80,000	2,00,000+80,000-20,000	2,60,000
Other Income	2	3,000	0	3,000-3,000	0
Total Revenue		**2,03,000**	**80,000**		**2,60,000**

Expenses					
Raw materials consumed	3	1,10,000	48,000	1,10,000+48,000-20,000	1,38,000
Change in inventories finished stock	4	-5,000	-3,000	(-5,000-3,000)	-8,000
Employee benefit expenses		30,000	10,000	30,000+10,000	40,000
Finance Costs	5	2,700	1,000	2,700+1,000-1,000	2,700
Depreciation		7,000	4,000	7,000+4,000	11,000
Other expense	6	10,350	6,040	10,350+6,040-2,000	14,390
Total Expenses		**1,55,050**	**66,040**		**1,98,090**
Profit Before Tax		47,950	13,960		61,910
Tax Expense :					
Current Tax		15,000	4,000	15,000+4,000	19,000
Deferred Tax		2,000	1,000	2,000+1,000	3,000
		17,000	5,000		22,000
Profit After Tax		**30,950**	**8,960**		**39,910**
Profit attributable to :					
Parent					37,222
Non-controlling interest					2,688
II. Statement of Other Comprehensive Income					
Fair value gain on investment in subsidiary	8	1,000	0	1,000+0-1,000	0
Fair value gain on other non-current investments	8	500	250	500+250	750
		1,500	**250**		**750**
Other comprehensive income attributable to :					
Parent					675
Non-Controlling Interests					75

Consolidated Statement of changes in Equity For the year ended on 31 March 20X2							
	Share Capital	General Reserve	Retained earnings	Fair Value Reserve	Total	Non-Controlling Interest	Group Total
Balance as on 1.4.20X1	20,000	1,00,000	20,000		1,40,000	16,500	1,56,500
Dividend for the year 20X0-20X1			(8,000)		(8,000)		(8,000)
Dividend distribution tax			(1,350)		(1,350)		(1,350)
Dividend received from subsidiary			1,680		1,680		1,680
Profit for the year 20X1-20X2			37,222		37,222	2,688	39,910
Fair value gain on investment in subsidiary							
Fair value gain on other non-current investments				675	675	75	750
Transfer to reserve		20,000	(20,000)		0		0
Dividend from subsidiary			(1,680)		(1,680)	(720)	(2,400)
Dividend distribution tax of subsidiary			(280)		(280)	(120)	(400)
Balance as on 31.3.20X2	20,000	1,20,000	27,592	675	1,68,267	18,423	1,86,690

Dividend and dividend distribution tax paid by the subsidiary is deducted from profit and non controlling interest.

Note: As per the response to Issue 1 given in ITFG Bulletin 9, in the consolidated financial statements of parent company, the dividend income earned by parent company from subsidiary company and dividend recorded by subsidiary company in its equity will both get eliminated as a result of consolidation adjustments. DDT paid by subsidiary company outside the consolidated Group i.e. to the tax authorities should be charged as expense in the consolidated statement of Profit and Loss of holding company.

If DDT paid by the subsidiary is allowed as a set off against the DDT liability of its parent (as per the tax laws), then the amount of such DDT should be recognised in the consolidated statement of changes in equity of parent company.

Consolidated Balance Sheet

As on 31 March 20X2

(Amount in ₹ lakhs)

	P Ltd	Q Ltd	Workings	Group
Assets				
Non-Current Assets				
Fixed Assets				
Property Plant Equipment	1,17,000	45,000	1,17,000+45,000	1,62,000
Goodwill				2,500
Financial Assets:				
Non-Current Investments	40,820	1,250	5,500+1,250	6,750
Long term loans	10,000	0	10,000+0-10,000	0
	1,67,820	46,250		1,71,250
Current Assets				
Inventories	35,000	15,000	35,000+15,000	50,000
Financial Assets:				
Trade Receivables	10,000	8,000	10,000+8,000-3,000	15,000
Cash and Cash Equivalents	930	4,200	930+4,200	5,130
	45,930	27,200		70,130
Total Assets	**2,13,750**	**73,450**		**2,41,380**
Equity and Liabilities				
Share Capital	20,000	10,000	SOCE	20,000
Other Equity	1,43,100	46,410	SOCE	1,48,267
Non-controlling interest			SOCE	18,423
	1,63,100	56,410		1,86,690
Non-current Liabilities				
Financial Liabilities:				
Borrowings	30,000	10,000	30,000+10,000-10,000	30,000
Deferred tax liabilities	7,000	2,000	7000+2,000	9,000
Long term provisions	4,600	930	4,600+930	5,530
	41,600	12,930		44,530

Current Liabilities				
Financial Liabilities:				
Trade Payables	8,000	4,000	8,000+4,000-3,000	9,000
Short term Provisions	1,050	110	1,050+110	1,160
	9,050	4,110		10,160
Total Liabilities	50,650	17,040		54,690
Total Equity & Liabilities	**2,13,750**	**73,450**		**2,41,380**

Statement of Cash Flows

For the year ended on 31 March 20X2

	P Ltd	Q Ltd	Workings	Group
I. Cash flows from operating activities				
Profit after Tax	30,950	8,960		39,910
Add Back				
Current Tax	15,000	4,000	15,000+4,000	19,000
Deferred Tax	2,000	1,000	2,000+1,000	3,000
Depreciation	7,000	4,000	7,000+4,000	11,000
Finance Costs	2,700	1,000	2,700+1,000-1,000	2,700
Change in Provisions	(1,350)	(1,960)	(1350) +1960	(3,310)
Reversal of Interest Income	(1,000)	0	(1,000) +0 +1,000	0
Working capital adjustments				
Inventories	(15,000)	(5,000)	30,000-50,000	-20,000
Trade Receivables	(2,000)	2,000	18,000-15,000	3,000
Trade Payables	2,000	2,000	8,000-9,000	1,000
	40,300	16,000		56,300
Less: Advance Tax	(15,000)	(4,000)	15,000+4,000	(19,000)
	25,300	12,000		37,300
II. Cash flows from investment activities				
Purchase of Property Plant Equipment	(17,000)	(5,000)	(17,000)-5,000	(22,000)

Acquisition of subsidiary	(36,000)	0	(36,000)+0	(36,000)
Interest Income	1,000		1,000-1,000	0
Dividend Income	1,680		1,680-1,680	0
	(50,320)	(5,000)		(58,000)
III. Cash flow from financing activities				
Dividend Payment	(8,000)	(2,400)	(8,000)-2,400+1,680	(8,720)
Dividend distribution tax	(1,350)	(400)	(1,350)-400	(1,750)
Interest payment	(2,700)	(1,000)	(2,700)-1,000+1,000	(2,700)
	(12,050)	(3,800)		(13,170)
Net Changes in Cash Flows (I+II+III)	(37,070)	3,200		(33,870)
Balance of Cash and Cash Equivalents as on 1.4.20X1	**38,000**	**1,000**	**38,000+1,000**	**39,000**
Balance of Cash and Cash Equivalents as on 31.3.20X2	**930**	**4,200**		**5,130**

While preparing Consolidated Statement of Cash flows also intra-group transactions are eliminated.

5.5.8 Reporting date

- The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements shall have the same reporting date.
- When the end of the reporting period of the parent is different from that of a subsidiary, the subsidiary prepares, for consolidation purposes, additional financial information as of the same date as the financial statements of the parent to enable the parent to consolidate the financial information of the subsidiary, unless it is impracticable to do so.
- If it is impracticable to do so, the parent shall consolidate the financial information of the subsidiary using the most recent financial statements of the subsidiary adjusted for the effects of significant transactions or events that occur between the date of those financial statements and the date of the consolidated financial statements.
- In any case, the difference between the date of the subsidiary's financial statements and that of the consolidated financial statements shall be no more than three months, and the length of the reporting periods and any difference between the dates of the financial statements shall be the same from period to period.

Illustration 20

How should assets and liabilities be classified into current or non-current in consolidated financial statements when parent and subsidiary have different reporting dates?

Solution

Paragraphs B92 and B93 of Ind AS 110 require subsidiaries with reporting period end different from parent, to provide additional information or details of significant transactions or events if it is impracticable to provide additional information to enable the parent entity to consolidate such financial information at group's reporting period end.

The appropriate classification of the assets and liabilities as current or non-current in the consolidated financial statements has to be determined by reference to the reporting period end of the group. Accordingly, when a subsidiary's financial statements are for a different reporting period end, it is necessary to review the subsidiary's balance sheet to ensure that items are correctly classified as current or non-current as at the end of the group's reporting period.

For example, a subsidiary with the financial year end of 31st December, 20X1 has a payable outstanding that is due for payment on 1st January, 20X3, and has accordingly classified it as non-current in its balance sheet. The financial year end of the parent's consolidated financial statements is 31st March 31, 20X3. Due to the time lag, the subsidiary's payable falls due within 12 months from the end of the parent's reporting period.

Accordingly, in this case, the payable should be classified as a current liability in the consolidated financial statements of the parent because the amount is repayable within nine months of the end of the parent's reporting period.

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Illustration 21

A Limited, an Indian Company has a foreign subsidiary, B Inc. Subsidiary B Inc. has taken a long term loan from a foreign bank, which is repayable after in the year 20X9. However, during the year ended 31st March, 20X2, it breached one of the conditions of the loan, as a consequence of which the loan became repayable on demand on the reporting date. Subsequent to year end but before the approval of the financial statements, B Inc. rectified the breach and the bank agreed not to demand repayment and to let the loan run for its remaining period to maturity as per the original loan terms. While preparing its standalone financial statements as per IFRS, B Inc. has classified this loan as a current liability in accordance with IAS 1, Presentation of Financial Statements.

Whether A limited is required to classify such loan as current while preparing its consolidated financial statement under Ind AS?

Solution

As per paragraph 74 of Ind AS 1, where there is a breach of a material provision 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 on the reporting date, the entity does not classify the liability as current, if the lender agreed, after the reporting period and before the approval of the financial statements for issue, not to demand payment as a consequence of the breach.

The above position under Ind AS 1 differs from the corresponding position under IAS 1. As per paragraph 74 of IAS 1, when an entity breaches a provision 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 period and before the authorisation of the financial statements for issue, not to demand payment as a consequence of the breach. An 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 twelve months after that date.

Accordingly, the loan liability recognised as current liability by B Inc. in its standalone financial statements prepared as per IFRS, should be aligned as per Ind AS in the consolidated financial statements of A Limited and should be classified as non-current in the consolidated financial statements of A Limited in accordance with Ind AS 1.

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5.5.9 Non–controlling interests

A parent shall present non-controlling interests in the consolidated balance sheet within equity, separately from the equity of the owners of the parent.

Changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are equity transactions (ie transactions with owners in their capacity as owners).

An entity shall attribute the profit or loss and each component of other comprehensive income to the owners of the parent and to the non-controlling interests. The entity shall also attribute total comprehensive income to the owners of the parent and to the non - controlling interests even if this results in the non-controlling interests having a deficit balance.

If a subsidiary has outstanding cumulative preference shares that are classified as equity and are held by non-controlling interests, the entity shall compute its share of profit or loss after adjusting for the dividends on such shares, whether or not such dividends have been declared.

5.5.9.1 Changes in the proportion held by non-controlling interests:

When the proportion of the equity held by non-controlling interest changes, an entity shall adjust the carrying amounts of the controlling and non-controlling interests to reflect the changes in their relative interests in the subsidiary. The entity shall recognize directly in equity any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received, and attribute it to the owners of the parent.

Illustration 22: Treatment of goodwill and non-controlling interest where a parent holds an indirect interest in a subsidiary.

A parent company (entity A) has an 80% owned subsidiary (entity B). Entity B makes an acquisition for cash of a third company (entity C), which it then wholly owns. Goodwill of ₹ 1,00,000 arises on the acquisition of entity C.

How should that goodwill be reflected in consolidated financial statement of entity A? Should it be reflected as:

a. 100% of the goodwill with 20% then being allocated to the non- controlling interest; or

b. 80% of the goodwill that arises?

Solution

Assuming that entity B prepares consolidated financial statements, 100% of the goodwill would be recognized on the acquisition of entity C in those financial statements. Entity A should reflect 100% of goodwill and allocate 20% to the non- controlling interest in its consolidated financial statements. This is because the non- controlling interest is a party to the transaction and the goodwill forms part of the net assets of the sub group (in this case, the sub group being the group headed by entity B).

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Illustration 23: Sale of 20% interest in a wholly- owned subsidiary

Entity P sells a 20% interest in a wholly- owned subsidiary to outside investors for ₹ 100 lakh in cash. The carrying value of the subsidiary's net assets is ₹ 300 lakh, including goodwill of ₹ 65 lakh from the subsidiary's initial acquisition.

Pass journal entries to record the transaction.

Solution

The accounting entry recorded on the disposition date for the 20% interest sold as follows:

		₹ in lakh	₹ in lakh
Cash	Dr.	100	
To Non-controlling interest (20% x 300 lakh)			60
To Other Equity (Gain on sale of interest in subsidiary)			40

As per para B96 of Ind AS 110, where proportion of the equity of NCI changes, then group shall adjust controlling and non-controlling interest and any difference between NCI (60 lakhs) is adjusted and fair value of consideration received (100 lakhs) to be attributed to parent in other equity ie. 40 lakhs.

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Illustration 24: Acquisition of 20% interest in a subsidiary

Entity A acquired 60% of entity B two years ago for ₹ 6,000. At the time entity B's fair value was ₹ 10,000. It had net assets with a fair value of ₹ 6,000 (which for the purposes of this example was the same as book value). Goodwill of ₹ 2,400 was recorded (being ₹ 6,000 – (60% x ₹ 6,000). On 1 October 20X0, entity A acquires a further 20% interest in entity B, taking its holding to 80%. At that time the fair value of entity B is ₹ 20,000 and entity A pays ₹ 4,000 for the 20% interest. At the time of the purchase the fair value of entity B's net assets is ₹ 12,000 and the carrying amount of the non- controlling interest is ₹ 4,000.

Pass journal entries to record the transaction.

Solution

The accounting entry recorded for the purpose of the non- controlling interest is as follows:

		₹	₹
Non-controlling interest	Dr.	2,000	
Other Equity (Loss on acquisition of interest in subsidiary)	Dr.	2,000	
To Cash			4,000

As per para B96 of Ind AS 110, where proportion of the equity of NCI changes, then group shall adjust controlling and non-controlling interest and any difference between NCI (₹ 2,000) is adjusted and fair value of consideration received (₹ 4,000) to be attributed to parent in other equity ie. ₹ 2,000.

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Illustration 25

A Ltd. acquired 10% additional shares of its 70% subsidiary. The following relevant information is available in respect of the change in non-controlling interest on the basis of Balance sheet finalized as on 1.4.20X0:

	₹ in thousand
Separate financial statements	***As on 31.3.20X0***
Investment in subsidiary (70% interest) – at cost	*14,000*
Purchase price for additional 10% interest	*2,600*
Consolidated financial statements	
Non-controlling interest (30%)	*6,600*
Consolidated profit & loss account balance	*2,000*
Goodwill	*600*

The reporting date of the subsidiary and the parent is 31 March, 20X0. Prepare note showing adjustment for change of non-controlling interest. Should goodwill be adjusted for the change?

Solution

The following accounting entries are passed:

		₹ '000	**₹ '000**
Other Equity (Loss on acquisition of interest in subsidiary)	Dr.	400	
Non-controlling interest	Dr.	2,200	
To Bank			2,600

As per para B96 of Ind AS 110, where proportion of the equity of NCI changes, then group shall adjust controlling and non-controlling interest and any difference between NCI (₹ 22,00,000) is adjusted and fair value of consideration received (₹ 26,00,000) to be attributed to parent in other equity ie. ₹ 4,00,000.

Consolidated goodwill is not adjusted.

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Illustration 26

A Ltd. acquired 70% of shares of B Ltd. On 1.4.20X0 when fair value of net assets of B Ltd. was ₹ 200 lakh. During 20X0-20X1, B Ltd. made profit of ₹ 100 lakh. Individual and consolidated balance sheets as on 31.3.20X1 are as follows: *(₹ in lakhs)*

	A	B	Group
Assets			
Goodwill			*10*
PPE	*627*	*200*	*827*
Financial Assets:			
Investments	*150*		
Cash	*200*	*30*	*230*
Other Current Assets	*23*	*70*	*93*
	1,000	*300*	*1,160*
Equity and Liabilities			
Share Capital	*200*	*100*	*200*
Other Equity	*800*	*200*	*870*
Non-controlling interest			*90*
	1,000	*300*	*1,160*

A Ltd. acquired another 10% stake in B ltd on 1.4.20X1 at ₹ 32 lakh. The proportionate carrying amount of the non-controlling interest is ₹ 30 lakh. Show the individual and consolidated balance sheet of the group immediately after the change in non-controlling interest.

Solution (₹ in lakhs)

	A	B	Workings	Group
Assets				
Goodwill				10
PPE	627	200		827
Financial Assets:				
Investments (150 + 32)	182	0		
Cash* (200 - 32)	168	30	(200+30)-32	198
Other Current Assets	23	70		93
	1,000	300		1,128
Share Capital	200	100		200
Other Equity	800	200	870-2	868
Non-controlling interest			90-30	60
	1,000	300		1,128

Other Equity (Loss on acquisition of interest in subsidiary)	Dr.	2	
Non-controlling interest	Dr.	30	
To Bank			32

*Cash has been adjusted through Individual Balance Sheet.

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Illustration 27: Reduce interest in subsidiary

Amla Ltd. purchase a 100% subsidiary for ₹ 10,00,000 at the end of 20X1 when the fair value of the subsidiary's Lal Ltd. net asset was ₹ 8,00,000.

The parent sold 40% of its investment in the subsidiary in March 20X4 to outside investors for ₹ 9,00,000. The parent still maintains a 60% controlling interest in the subsidiary. The carrying value of the subsidiary's net assets is ₹ 18,00,000 (including net assets of ₹ 16,00,000 & goodwill of ₹ 2,00,000).

Calculate gain or loss on sale of interest in subsidiary as on 31st March 20X4.

Solution

As per Ind AS 110, a change in ownership that does not result in a loss of control. The identifiable net assets (including goodwill) remain unchanged and any difference between the amount by which the non-controlling interest is recorded (including the non-controlling interest portion of goodwill) and a fair value of the consideration received is recognized directly in equity and attributed to the controlling interest. For disposals that do not result in the loss of control, the change in the non-controlling interest is recorded at its proportionate interest of the carrying value of the subsidiary.

Gain on the sale of the investment of ₹ 5,00,000 in parent's separate financial statements calculated as follows:

	₹'000
Sale proceeds	900
Less: Cost of investment in subsidiary (₹ 10,00,000 X 40%)	(400)
Gain on sale in the parent's separate financial statement	500

As discussed above, the group's consolidated income statement for 31st March 20X4 would show no gain on the sale of the interest in the subsidiary. Instead, the difference between the fair value of the consideration received and the amount by which the non-controlling interest is recorded is recognized directly in equity.

	₹'000
Sale proceeds	900
Less: Recognition of non-controlling interest (₹ 18,00,000 X 40%)	(720)
Credit to other equity	180

The entry recognized in the consolidated accounts under Ind AS 110 is :

		₹'000	₹'000
Cash	Dr.	900	
To Non-controlling interest			(1,800 x 40%) 720
To Other Equity (Gain on sale of interest on subsidiary)			180

The difference between the gain in the parent's income statement and the increase reported in the group's consolidated equity is ₹ 3,20,000. This difference represents the share of post-acquisition profits retained in the subsidiary ₹ 3,20,000 [(that is, 18,00,000 – 10,00,000) x 40%] that have been reported in the groups income statement upto the date of sale.

The non-controlling interest immediately after the disposal will be 40% of the net carrying value of the subsidiary's net assets including goodwill in the consolidated balance sheet of ₹ 18,00,000, that is, ₹ 7,20,000.

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Illustration 28

Entity A sells a 30% interest in its wholly-owned subsidiary to outside investors in an arm's length transaction for ₹ 500 crore in cash and retains a 70% controlling interest in the subsidiary. At the time of the sale, the carrying value of the subsidiary's net assets in the consolidated financial statements of Entity A is ₹ 1,300 crore, additionally, there is a goodwill of ₹ 200 crore that arose on the subsidiary's acquisition. Entity A initially accounted for NCI representing present ownership interests in the subsidiary at fair value and it recognises subsequent changes in NCI in the subsidiary at NCI's proportionate share in aggregate of net identifiable assets and associated goodwill. How should Entity A account for the transaction?

Solution

As per paragraph 23 of Ind AS 110, changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are equity transactions (i.e. transactions with owners in their capacity as owners). Thus, changes in ownership interest that do not result in loss of control do not impact goodwill associated with the subsidiary or the statement of profit and loss.

Paragraph B96 of Ind AS 110 states that when the proportion of the equity held by non-controlling interests changes, an entity shall adjust the carrying amounts of the controlling and non-controlling interests to reflect the changes in their relative interests in the subsidiary. The entity shall recognise directly in equity any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received, and attribute it to the owners of the parent.

Thus, at the time of sale of 30% of its equity interest, consolidated financial statements include an amount of ₹ 1,500 crore in respect of the subsidiary. Accordingly, in the present case, the accounting entry on the date of sale of the 30% interest would be as follows:

		(Rupees in crore)	
Cash	Dr.	500	
To NCI (30% of 1,500 crore)			450
To Equity			50

*****

5.5.10 Loss of control

A parent can lose control of subsidiaries in a number of ways. These include:

- Loss of control due to outright sale – where the entire stake is sold off;
- Loss of control due to partial sale – where the parent retains interest as an associate, jointly controlled entity or a financial asset;
- Deemed loss of control where no consideration is received but the parent's interest is diluted in some other manner such as
  - voting rights issued to a new investor;
  - control on relevant activities;
  - consolidation of voting rights of other shareholder's;
  - an investor acquiring substantial stake from the stock exchange.
- In addition to Ind AS 110, for Consolidated Balance Sheet, requirements of Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations should also be considered.

If a parent loses control of a subsidiary, the parent:

- derecognizes the assets and liabilities of the former subsidiary from the consolidated balance sheet.
- recognizes any investment retained in the former subsidiary at its fair value when control is lost and subsequently accounts for it and for any amounts owed by or to the former subsidiary in accordance with relevant Ind ASs. That fair value shall be regarded as the fair value on initial recognition of a financial asset in accordance with Ind AS 109 or, when appropriate, the cost on initial recognition of an investment in an associate or joint venture.
- recognizes the gain or loss associated with the loss of control attributable to the former controlling interest.

A parent might lose control of a subsidiary in two or more arrangements (transactions). However, sometimes circumstances indicate that the multiple arrangements should be accounted for as a single transaction. In determining whether to account for the arrangements as a single transaction, a parent shall consider all the terms and conditions of the arrangements and their economic effects. One or more of the following indicate that the parent should account for the multiple arrangements as a single transaction:

- They are entered into at the same time or in contemplation of each other.
- They form a single transaction designed to achieve an overall commercial effect.
- The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.
- One arrangement considered on its own is not economically justified, but it is economically justified when considered together with other arrangements. An example is when a disposal of shares is priced below market and is compensated for by a subsequent disposal priced above market.

If a parent loses control of a subsidiary, it shall:

- derecognize:
  - the assets (including any goodwill) and liabilities of the subsidiary at their carrying amounts at the date when control is lost; and
  - the carrying amount of any non-controlling interests in the former subsidiary at the date when control is lost (including any components of other comprehensive income attributable to them).
- recognize:
  - the fair value of the consideration received, if any, from the transaction, event or circumstances that resulted in the loss of control;
  - if the transaction, event or circumstances that resulted in the loss of control involves a distribution of shares of the subsidiary to owners in their capacity as owners, that distribution; and
  - any investment retained in the former subsidiary at its fair value at the date when control is lost.
- reclassify to profit or loss, or transfer directly to retained earnings if required by other Ind AS, the amounts recognized in other comprehensive income in relation to the subsidiary on the basis described in paragraph B99.
- recognize any resulting difference as a gain or loss in profit or loss attributable to the parent.

If a parent loses control of a subsidiary, the parent shall account for all amounts previously recognized in other comprehensive income in relation to that subsidiary on the same basis as would be required if the parent had directly disposed of the related assets or liabilities. Therefore, if a gain or loss previously recognized in other comprehensive income would be reclassified to profit or loss on the disposal of the related assets or liabilities, the parent shall reclassify the gain or loss from equity to profit or loss (as a reclassification adjustment) when it loses control of the subsidiary. If a revaluation surplus previously recognized in other comprehensive income would be transferred directly to retained earnings on the disposal of the asset, the parent shall transfer the revaluation surplus directly to retained earnings when it loses control of the subsidiary.

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Illustration 29: Subsidiary issues shares to a third party and parent loses control

In March 20X1 a group had a 60% interest in subsidiary with share capital of 50,000 ordinary shares. The carrying amount of goodwill is ₹ 20,000 at March 20X1 calculated using the partial goodwill method. On 31 March 20X1, an option held by the minority shareholders exercised the option to subscribe for a further 25,000 ordinary shares in the subsidiary at ₹ 12 per share, raising ₹ 3,00,000. The net assets of the subsidiary in the consolidated balance sheet prior to the option's exercise were ₹ 4,50,000, excluding goodwill.

Calculate gain or loss on loss of interest in subsidiary due to option exercised by minority shareholder.

Solution

Shareholdings

	Before		**After**	
	No	**%**	**No**	**%**
Group	30,000	60	30,000	40
Other party	20,000	40	45,000	60
	50,000	100	75,000	100
Net assets	**₹'000**	**%**	**₹'000**	**%**
Group's share	270	60	300	40
Other party's share	180	40	450	60
	450	100	750	100

Calculation of group gain on deemed disposal	**₹'000**
Fair value of 40% interest retained (₹ 12 x 30,000)**	360
Less: Net assets derecognized	(450)
Non-controlling interest derecognized	180
Goodwill	(20)
Gain on deemed disposal	70

**Note: For simplicity, it has been assumed the fair value per share is equal to the subscription price.

As control of the subsidiary is lost, the retained interest is recognized at its fair value at the date control is lost. The resulting remeasurement gain is recognized in profit and loss.

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Illustration 30: Calculation of gain on outright sale of subsidiary

A parent purchased an 80% interest in a subsidiary for ₹ 1,60,000 on 1 April 20X1 when the fair value of the subsidiary's net assets was ₹ 1,75,000. Goodwill of ₹ 20,000 arose on consolidation under the partial goodwill method. An impairment of goodwill of ₹ 8,000 was charged in the consolidated financial statements to 31 March 20X3. No other impairment charges have been recorded. The parent sold its investment in the subsidiary on 31 March 20X4 for ₹ 2,00,000. The book value of the subsidiary's net assets in the consolidated financial statements on the date of the sale was ₹ 2,25,000 (not including goodwill of ₹ 12,000). When the subsidiary met the criteria to be classified as held for sale under Ind AS 105, no write down was required because the expected fair value less cost to sell (of 100% of the subsidiary) was greater than the carrying value.

The parent carried the investment in the subsidiary at cost, as permitted by Ind AS 27.

Calculate gain or loss on disposal of subsidiary in parent's separate and consolidated financial statements as on 31st March 20X4.

Solution

The parent's separate statement of profit and loss for 20X3-20X4 would show a gain on the sale of investment of ₹ 40,000 calculated as follow:

	₹ '000
Sale proceeds	200
Less: Cost of investment in subsidiary	(160)
Gain on sale in parent's account	40

However, the group's statement of profit & loss for 20X3-20X4 would show a gain on the sale of subsidiary of ₹ 8,000 calculated as follows:

		₹'000
Sale proceeds		200
Less: Share of net assets at date of disposal (₹ 2,25,000 X 80%)	(180)	
Goodwill on consolidation at date of sale (W.N 1)	(12)	(192)
Gain on sale in the group's account		8

Working Note

The goodwill on consolidation (assuming partial goodwill method) is calculated as follows:

	₹'000
Fair value of consideration at the date of acquisition	160

Non- controlling interest measured at proportionate share of the acquiree's identifiable net assets (1,75,000 X 20%)	35	
Less: Fair value of net assets of subsidiary at date of acquisition	(175)	(140)
Goodwill arising on consolidation		20
Impairment at 31 March 20X3		(8)
Goodwill at 31 March 20X4		12

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Illustration 31: Partial disposal where subsidiary becomes an associate

AT Ltd. purchased a 100% subsidiary for ₹ 50,00,000 on 31st March 20X1 when the fair value of the BT Ltd. whose net assets was ₹ 40,00,000. Therefore, goodwill is ₹10,00,000. The AT Ltd. sold 60% of its investment in BT Ltd. on 31st March 20X3 for ₹ 67,50,000, leaving the AT Ltd. with 40% and significant influence. At the date of disposal, the carrying value of net assets of BT Ltd., excluding goodwill is ₹ 80,00,000. Assume the fair value of the investment in associate BT Ltd. retained is proportionate to the fair value of the 60% sold, that is ₹ 45,00,000.

Calculate gain or loss on sale of proportion of BT Ltd. in AT Ltd.'s separate and consolidated financial statements as on 31st March 20X3.

Solution

AT Ltd.'s statement for profit or loss of 20X2-20X3 would show a gain on the sale of investment of ₹ 37,50,000 calculated as follows:

	₹' lakhs
Sale proceeds	67.5
Less: Cost on investment in subsidiary (₹ 50,00,000 X 60%)	(30.0)
Gain on sale in the parent's financial statement	37.5

In the consolidated financial statements, the group will calculate the gain or loss on disposal differently. The carrying amount of all of the assets including goodwill is derecognized when control is lost. This is compared to the proceeds received and the fair value of the investment retained.

The gain on the disposal will, therefore, be calculated as follows:

	₹' lakhs
Sale proceeds	67.5
Fair value of 40% interest retained	45.0
	112.5
Less: Net assets disposed, including goodwill (80,00,000+ 10,00,000)	(90.0)
Gain on sale in the group's financial statements	22.5

The gain on loss of control would be recorded in profit or loss. The gain or loss includes the gain of ₹ 13,50,000 [₹ 67,50,000 – (₹ 90,00,000 x 60%)] on the portion sold. However, it also includes a gain on remeasurement of the 40% retained interest of ₹ 9,00,000 (₹ 36,00,000* to ₹ 45,00,000). The entity will need to disclose the portion of the gain that is attributable to remeasuring any remaining interest to fair value, that is, ₹ 9,00,000.

* 90,00,000 x 40%= 36,00,000

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Illustration 32: Partial disposal where 10% investment in former subsidiary is retained.

The facts of this illustration are same as illustration 27, except that the group AT Ltd. disposes of a 90% interest for ₹ 85,50,000, leaving the AT Ltd. with a 10% investment. The fair value of the remaining interest is ₹ 9,50,000 (assumed for simplicity to be pro rata to the fair value of the 90% sold).

Calculate gain or loss on sale of proportion of BT Ltd. in AT Ltd.'s separate and consolidated financial statements as on 31st March 20X1.

Solution

The parent's AT Ltd. income statement in its separate financial statements for 20X1 would show a gain on the sale of the investment of ₹ 40,50,000 calculated as follows:

	₹ in lakhs
Sale proceeds	85.5
Less: Cost on investment in subsidiary (₹ 50,00,000 X 90%)	(45.0)
Gain on sale in the parent's financial statement	40.5

In the consolidated financial statements, all of the assets, including goodwill are derecognized when control is lost. This is compared to the proceeds received and the fair value of the investment retained.

	₹ in lakhs
Sale proceeds	85.5
Fair value of 10% interest retained	9.5
	95.0
Less: Net assets disposed, including goodwill (80,00,000+ 10,00,000)	(90.0)
Gain on sale in the group's financial statements	5.0

The gain on loss of control would be recorded in profit or loss. The gain or loss includes the gain of ₹ 4,50,000 related to the 90% portion sold [₹ 85,50,000 – (₹ 90,00,000 X 90%)] as well as ₹ 50,000 related to the remeasurement to fair value of 10% retained interest (₹ 9,00,000 to ₹ 9,50,000)

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5.5.11 Chain-holding under consolidation

5.5.11.1 Meaning of chain-holding

A parent company can establish control over subsidiary directly or indirectly. Chain-holding refers to situations wherein a parent is controlling a subsidiary indirectly, i.e., having a controlling interest over a company indirectly. This may happen in number of ways, for example, parent company (P Ltd.) holding controlling interest in a subsidiary (S1 Ltd.), which in turn is holding a controlling interest in another company (S2 Ltd.). In this case, P Ltd. is having an indirect control over S2 Ltd. through its direct subsidiary S1 Ltd.

5.5.11.2 Consolidation procedures in case of chain-holding

Holding in subsidiary may be of various structures like:

Situation I: Sub-subsidiaries

Parent P ⟶ 80% ⟶ Subsidiary S1 ⟶ 60% ⟶ Sub-Subsidiary (S2)

In the above case, P holds a controlling interest in S1 which in turn holds a controlling interest in S2.

S2 is therefore an indirect subsidiary of P, in other words, a sub-subsidiary of P.

Analysis:

1. P owns 80% of 60% = 48% of S2
2. The non-controlling interest (NCI) in S1 owns 20% of 60% = 12% of S2
3. The non-controlling interest (NCI) in S2 itself owns the remaining 40% of the S2 equity.

S2 is nevertheless a sub-subsidiary of P, because it is a subsidiary of S1 which in turn is a subsidiary of P. The chain of control thus makes S2 sub-subsidiary of P which owns only 48% of its equity.

Date of effective control:

The date the sub-subsidiary (S2) comes under the control of the holding company is either:

1. The date P acquired S1 if S1 already holds shares in S2, or
2. If S1 acquires shares in S2 later, ie after the acquisition be P in S1

Point to remember :

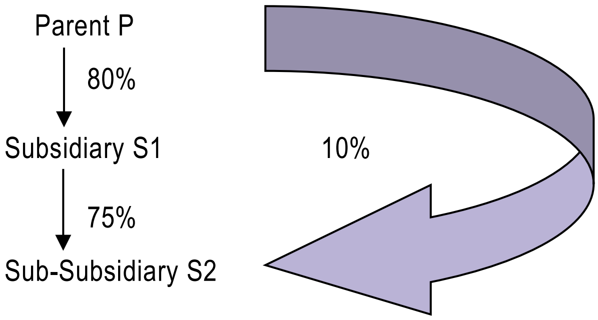
The **dates of acquisition** and the order in which the group is built up should be considered while identifying as which balances to select as the pre-acquisition reserves of the sub-subsidiary.

Care must be taken when consolidating sub-subsidiaries, because (usually) either:

1. The parent company acquired the subsidiary before the subsidiary bought the sub-subsidiary.

2. The parent holding company acquired the subsidiary after the subsidiary bought the sub-subsidiary
3. Depending on whether (1) or (2) is the case, the retained earnings of the subsidiary at acquisition will be different.

Situation II: Direct holdings in sub-subsidiaries:



In this case, S2 is a sub-subsidiary of P with additional shares held directly by P.

In the above case, there is:

1.	**Direct** non-controlling share (NCI) in S1 of	20%	
2.	**Direct** non-controlling share (NCI) in S2 of (25-10)	15%	
3.	**Indirect** non-controlling share (NCI) in S2 of 20% x 75%	15%	30%

Analysis:

The effective interest in SS is:

Group (80% x 75%)	60% interest
Direct holding	10%
	70%
Thus, NCI	30%
	100%

Note: Once we have ascertained the structure and non-controlling interests, we can proceed as we do for case A.

Illustration 33

Prepare the consolidated Balance Sheet as on 31st March, 20X2 of a group of companies comprising P Limited, S Limited and SS Limited. Their balance sheets on that date are given below:

₹ in lakhs

	P Ltd.	S Ltd.	SS Ltd.
Assets			
Non-Current Assets			
Property, Plant and Equipment	320	360	300
Investment :			
16 lakhs shares in S Ltd.	340		
12 Lakhs shares in SS Ltd.		280	
Current Assets			
Inventories	220	70	50
Financial Assets			
Trade Receivables	260	100	220
Bills Receivable	72	-	30
Cash in hand and at Bank	228	40	40
	1440	850	640
Equity and Liabilities			
Shareholder's Equity			
Share capital (₹ 10 per Share)	600	400	320
Other Equity			
Reserves	180	100	80
Retained earnings	160	50	60
Current Liabilities			
Financial Liabilities			
Trade Payables	470	230	180
Bills Payable			
P Ltd.		70	
SS Ltd.	30		
	1440	**850**	**640**

The following additional information is available :

(i) P Ltd. holds 80% shares in S Ltd. and S Ltd. holds 75% shares in SS Ltd. Their holdings were acquired on 30th September, 20X1.

(ii) The business activities of all the companies are not seasonal in nature and therefore, it can be assumed that profits are earned evenly throughout the year.

(iii) On 1st April, 20X1 the following balances stood in the books of S Limited and SS Limited.

₹ in lakhs

	S Limited	*SS Limited*
Reserves	*80*	*60*
Retained earnings	*20*	*30*

(iv) ₹ 10 lakhs included in the inventory figure of S Limited, is inventory which has been purchased from SS Limited at cost plus 25%.

(v) The parent company has adopted an accounting policy to measure non-controlling interest at fair value (quoted market price) applying Ind AS 103. Assume market prices of S Limited and SS Limited are the same as respective face values.

Solution

Consolidated Balance Sheet of the Group as on 31st March, 20X2

Particulars	Note No.	(₹ in lakh)
ASSETS		
Non-current assets		
Property, plant and equipment	1	980
Current assets		
(a) Inventory	2	338
(b) Financial assets		
Trade receivables	3	580
Bills receivable	4	2
Cash and cash equivalents	5	308
Total assets		**2,208**
EQUITY & LIABILITIES		
Equity attributable to owners of the parent		
Share capital		600
Other Equity		
Reserves (W.N.5)		194
Retained Earnings (W.N.5)		179.8
Capital Reserve (W.N.3)		188
Non-controlling interests (W.N.4)		166.2
Total equity		**1328**
LIABILITIES		
Non-current liabilities		Nil
Current liabilities		
(a) Financial Liabilities		
(i) Trade payables	6	880

Total liabilities		880
Total equity and liabilities		**2,208**

Notes to Accounts (₹ in lakh)

1.	**Property Plant & Equipment**		
	P Ltd.	320	
	S Ltd.	360	
	SS Ltd.	300	980
2.	**Inventories**		
	P Ltd.	220	
	S Ltd. (70-2)	68	
	SS Ltd.	50	338
3.	**Trade Receivables**		
	P Ltd.	260	
	S Ltd.	100	
	SS Ltd.	220	580
4.	**Bills Receivable**		
	P Ltd. (72-70)	2	
	SS Ltd. (30-30)	-	2
5.	**Cash & Cash equivalents**		
	P Ltd.	228	
	S Ltd.	40	
	SS Ltd.	40	308
6.	**Trade Payables**		
	P Ltd.	470	
	S Ltd.	230	
	SS Ltd.	180	880

Working Notes:

1. Analysis of Reserves and Surplus (₹ in lakh)

		S Ltd.		SS Ltd.
Reserves as on 31.3.20X1		80		60
Increase during the year 20X1-20X2	20		20	
Increase for the half year till 30.9.2017		10		10
Balance as on 30.9.20X1 (A)		**90**		**70**
Total balance as on 31.3.20X2		100		80
Post-acquisition balance		**10**		**10**

		S Ltd.		SS Ltd.
Retained Earnings as on 31.3.20X1		20		30
Increase during the year 20X1-20X2	30		30	
Increase for the half year till 30.9.20X1		15		15
Balance as on 30.9.20X1 (B)		**35**		**45**
Total balance as on 31.3.20X2		50		60
Post-acquisition balance		15		15
Less: Unrealised Gain on inventories (10 x 25%)		-		(2)
Post-acquisition balance for CFS		**15**		**13**
Total balance on the acquisition date ie.30.9.20X1 (A +B)		**125**		**115**

2. Calculation of Effective Interest of P Ltd. in SS Ltd.

Acquisition by P Ltd. in S Ltd. = 80%

Acquisition by S Ltd. in SS Ltd. = 75%

Acquisition by Group in SS Ltd. (80% x 75%) = 60%

Non Controlling Interest = 40%

3. Calculation of Goodwill / Capital Reserve on the acquisition date

	S Ltd.	SS Ltd.
Investment or consideration	340	(280 × 80%) 224
Add: NCI at Fair value		
(400 x 20%)	80	
(320 x 40%)		128
	420	352
Less: Identifiable net assets (Share capital + Increase in the Reserves and Surplus till acquisition date)	(400+125) (525)	(320+115) (435)
Capital Reserve	105	83
Total Capital Reserve (105 + 83)	188	

4. Calculation of Non Controlling Interest

	S Ltd.	SS Ltd.
At Fair Value (See Note 3)	80	128
Add: Post Acquisition Reserves (See Note 1)	(10 × 20%) 2	(10 × 40%) 4
Add: Post Acquisition Retained Earnings (See Note 1)	(15 × 20%) 3	(13 × 40%) 5.2

Less: NCI share of investment in SS Ltd.	(280 x 20%) (56)*	
	29	137.2
Total (29+ 137.2)	166.2	

*** Note:** The Non-controlling interest in S Ltd. will take its proportion in SS Ltd. so they have to bear their proportion in the investment by S Ltd. (in SS Ltd.) also.

5. Calculation of Consolidated Other Equity

	Reserves	Retained Earnings
P Ltd.	180	160
Add: Share in S Ltd.	(10 x 80%) 8	(15 × 80%) 12
Add: Share in SS Ltd.	(10 × 60%) 6	(13 × 60%) 7.8
	194	179.8

Note: It is assumed date the sale of goods by SS Ltd. is done after acquisition of shares by S Ltd. Alternatively, it may be assumed that the sale has either been done before acquisition of shares by S Ltd. in SS Ltd. or sale has been throughout the year. Accordingly, the treatment for unrealized gain may vary.

UNIT 6 : JOINT ARRANGEMENTS

6.1 INTRODUCTION

Ind AS 111, *Joint Arrangements,* describes principles for financial reporting by parties to a joint agreement. It is important for the management to understand the scope, impact and requirements for presentation of financial statement and balance sheet in case of any kind of joint arrangements. It has been observed that some agreements are called as 'joint arrangements' or 'joint ventures' but in reality, only one party has control. On the other hand, some arrangements are not referred as 'joint arrangement' or 'joint control', but may still be treated as joint arrangements, as defined by Ind AS 111. Hence the terminology used is not important to describe the arrangement. Here the management needs to carefully evaluate the terms and conditions based on which the arrangement is set up, and the relevant facts and circumstances, and thereby determine if it is eligible to be called as a joint arrangement. The accounting treatment will be decided based on the substance of the arrangement and the kind of interest investors have in it.

6.2 SCOPE

It covers all the entities that are party to a **joint arrangement** including venture capital organisations, mutual funds, unit trusts, investment-linked insurance funds and similar entities.

6.3 CONCEPT OF JOINT CONTROL

Two or more parties are said to be in joint arrangement only when there is **joint control**. It requires that all the decisions about the relevant activities are being taken unanimously by the parties sharing control.

1. **Collective control: -** Here, no single party enjoys full control. Here it is important to assess whether the contract gives all the parties or a group of parties, control of the arrangement. For this we first need to identify the relevant activities of the arrangement. This can be done by understanding the purpose of the arrangement and risk and returns involved in the activities. The activities which significantly affect the returns or the outcome of the arrangements can be determined as relevant activities. Then management needs to check whether all parties or group of parties are having collective control over these activities.

2. **Unanimous decision: -** There has to be unanimous consent of all the parties *having joint control* on the decisions for the arrangement. The requirement for unanimous consent means that any party with joint control of the arrangement can prevent any of the other parties, or a group of the parties, from making unilateral decisions (about the relevant activities) without its consent. Hence there is no single party that controls the arrangement.

There may be cases where the contract necessitates a minimum percentage of the voting rights to make decisions about the relevant activities. If that minimum required proportion of the voting rights can be achieved by more than one combination of the parties agreeing together, that arrangement is not a joint arrangement unless the contractual arrangement specifies which parties (or combination of parties) are required to agree unanimously to take decisions about the relevant activities of the arrangement.

Illustration 1

Two parties A & B agree in their contractual arrangement to establish an arrangement. Each has 50% of the voting rights. The contract specifies that at least 51% of the voting rights are required to make decisions with respect to the relevant activities. Do A & B have joint control over the arrangement?

Solution

A & B have implicitly agreed that they have joint control of the arrangement as all the relevant decisions can be made only when both the A & B agree.

*****

Illustration 2

There is an arrangement in which Ram and Shyam each have 35% of the voting rights in the arrangement with the remaining 30% being widely dispersed. Decisions about the relevant activities require approval by a majority of the voting rights. Do Ram & Shyam have joint control over the arrangement?

Solution

Ram and Shyam have joint control of the arrangement only if the contractual arrangement specifies that decisions about the relevant activities of the arrangement require both Ram and Shyam agreeing.

*****

Illustration 3

An arrangement has three parties: Om has 50% of the voting rights in the arrangement and Jay and Jagdish each have 25%. The contractual arrangement between Om, Jay and Jagdish specifies that at least 75% of the voting rights are required to make decisions about the relevant activities of the arrangement. Discuss the different combinations of joint control that can affect the decision making of the relevant activities of the arrangement?

Solution

Om can block any decision, it does not control the arrangement because it needs the agreement of either Jay or Jagdish. Om, Jay and Jagdish collectively control the arrangement. However, there is more than one combination of parties that can agree to reach 75% of the voting rights (ie either Om and Jay or Om and Jagdish). In such a situation, to be a joint arrangement the contractual arrangement between the parties would need to specify which combination of the parties is required to agree unanimously to take decisions about the relevant activities of the arrangement.

*****

Illustration 4: Implicit Joint control

Entity C and entity D operates in a telecommunication industry and entered into a joint arrangement in order to combine their 4G access networks. The purpose of this arrangement is to reduce operating cost for both parties, make capital infrastructure savings and obtain economies of scale from jointly managing and maintaining a consolidated network.

All significant decisions about strategic investing and financing activities are decided by a simple majority of the voting rights. Entity C and entity D each have one vote in the decision making process.

Discuss whether it is a joint arrangement or not.

Solution

All decisions about the relevant activities require consent of both parties, so the arrangement is a joint arrangement. The contractual arrangement does not explicitly require unanimous consent, but the fact that all decisions must be made by majority leads to implicit joint control.

*****

Illustration 5: Implicit joint control

NFG Limited is owned by numerous shareholders with the following holdings:

- *Shareholders N owns 51%*
- *Shareholders F owns 30%*
- *The rest of the shares are widely held by other investors, altogether 19%.*

NFG Limited's articles of association require a 75% majority to approve decisions about any of the entity's relevant activities. They also outline that each shareholder is entitled to vote in proportion to its respective ownership interest. Is NFG ltd jointly controlled?

Solution

NFG Limited is jointly controlled by shareholders N and F. based on their ownership interest (collectively 81%), they must act together to make decisions regarding NFG Limited's relevant activities. Shareholder N does not control NFG Limited, as it cannot unilaterally make decisions because a 75% majority is required.

*****

Illustration 6: Equal number of directors

Two entities, E and F, set up an entity and sign a joint operating agreement. The board is comprised of three directors appointed by and representing each entity. The board is the entity's main decision-making body. Decisions are made by simple majority. Each party has a 50% interest in the net profit generated. Discuss whether the entity is jointly controlled by E & F.

Solution

Entities E and F are likely to have joint control, because each party has a 50% interest in net profit and both have a right to appoint three directors. This is because the three directors representing a single shareholder would generally be presumed to vote in accordance with the wishes of that shareholder. So the consent of both entity E and entity F would be required for decision making, and this would represent joint control.

However, if the directors are not obliged to represent one shareholder, decisions will be made by simple majority. It is possible that (say) one director of shareholder E agrees with three directors of shareholder F and takes a decision that is against the interest of shareholder E. Although this is expected to be unlikely in practice, such a situation would not represent joint control.

All relevant facts have to be considered before reaching such a conclusion.

*****

Illustration 7: Board of directors and operating committee

Entities P and Q set up a joint venture company, entity PQ by signing a joint operating agreement. Both investors delegate one director to entity PQ's board of directors. Both directors have to agree unanimously on the decisions on the annual budget. The joint operating agreement also sets up an operating committee and specifies power delegated by the board of directors to the committee. The operating committee has the main operational decision-making responsibility. Decisions are made by simple majority in this committee. Only entity P can appoint members to the operating committee.

Discuss if Entity PQ is a joint arrangement or not.

Solution

Entity PQ is not a joint arrangement; entity P has control over entity PQ. Decisions about relevant activities are not made at the board of directors' level but at the operating committee level. Entity P has control over the operating committee because it can appoint its members. The fact that the directors have veto rights over the annual budget is important, but the operating committee in this example has the power to control entity PQ's relevant activities.

*****

Illustration 8

Hari and Ram enter into a contractual arrangement to buy a two storied music store, which they will lease to other parties. Hari will be responsible for leasing first floor and Ram will be responsible for leasing second floor. They can make all decisions related to their respective floors and keep all of the income with respect to their floors. Ground floor will be jointly managed — all decisions and with respect to ground floor must be unanimously agreed between Hari and Ram. Discuss the applicability of Ind AS 111.

Solution

There are three arrangements:

1. First floor that Hari controls and hence will not be accounted under Ind AS 111.
2. Second floor that Ram controls and thus will not be accounted under Ind AS 111.
3. Ground floors that Hari and Ram jointly control is a joint arrangement (within the scope of Ind AS 111).

*****

Illustration 9

Company AB and Company CD enter into an agreement for the production and sale of garments. In the industry, there are three activities that will significantly make impact on the returns of the arrangement:

1. *Production of the garments — Company AB makes all the decisions for this activity*
2. *Sales and Marketing activities — Company CD is makes all the decisions for these activities*
3. *Both the companies must approve all financial related matters*

Discuss whether company AB and CD have joint control over the arrangement?

Solution

In first two matters, unanimous consent is not required as long as parties are working within the approved budgets and financial constraints. Thus, the parties have liberty to perform their respective responsibilities.

Here, the parties have to examine which of the three activities most significantly affect the returns of the arrangement. If any of the first two activities determine the profits of the arrangement significantly, there is no joint control over the arrangement.

However, there may be the case where the financial policies majorly impact the execution of other two activities and hence determine the profit of the arrangement. Since unanimous consent is required for financial policies, management may conclude that there is joint control.

*****

Agreements established by informal decisions

Illustration 10

CDEF limited is a strategic co-operation between investors C, D, E and F to provide property development services. CDEF Limited is an incorporated entity, and the investors' share ownership is 20:30:25:25 respectively. There is a formal contractual agreement in place that requires a voting majority on all relevant activities. Investors C, D and E have informally agreed to vote together. This informal agreement has been effective in practice.

Does C, D & E have control over the joint arrangement?

Solution

To make decisions, it is sufficient to have agreement from any three out of the four investors. In this case, a single investor cannot prevent a majority decision. However, three of the investors have agreed to make unanimous decisions. Investors C, D and E, therefore, have joint control over CDEF Limited, with investor F having significant influence at best. The agreement between investors C, D and E does not have to be formally documented as long as there is evidence of its existence (for example, via correspondence and minutes of meetings).

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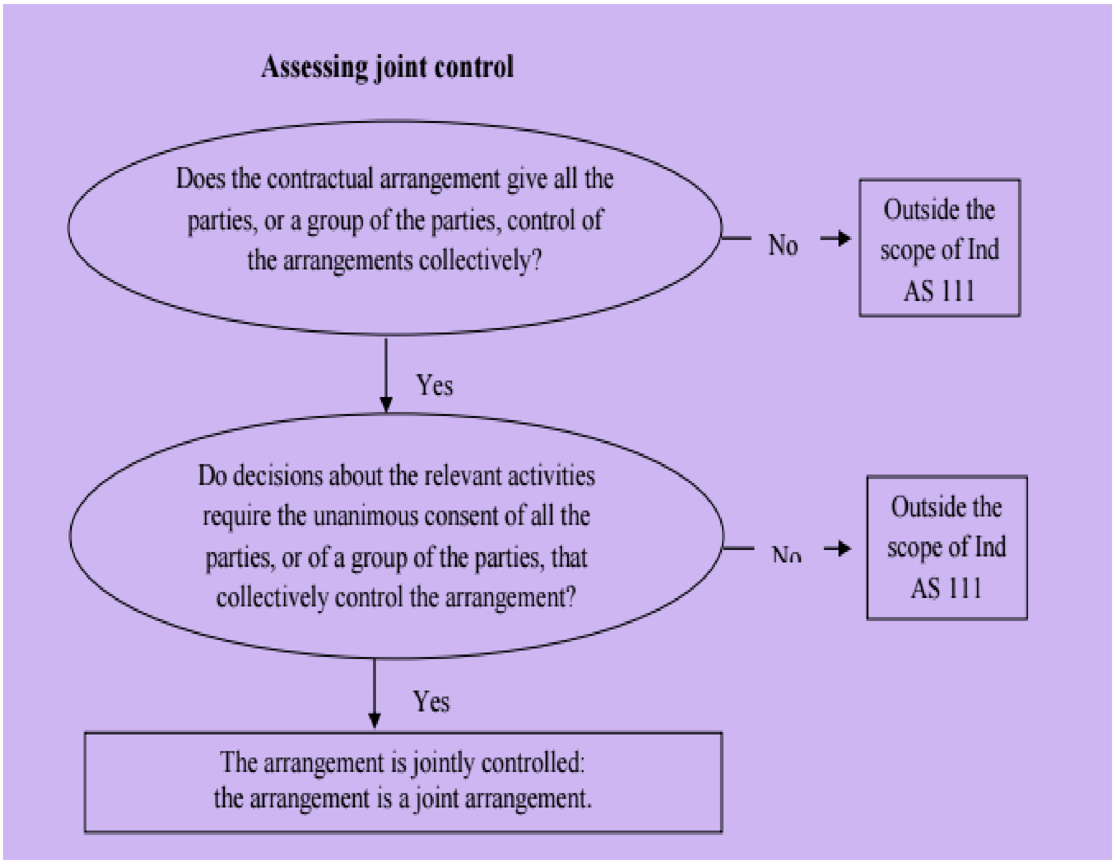


6.4 FEATURES OF JOINT ARRANGEMENTS

Sometimes ventures are named as joint arrangement but one party has control over the activities of the entity. In such cases the Ind AS 111 will not apply. On the other hand, there may be arrangements which are not referred as joint arrangements but still complies with the requirement of the Standard and hence follow the guidelines.

A joint arrangement is an arrangement where two or more parties have joint control over an entity under the contractual agreement. The two key characteristics are

6.4.1 Contractual Arrangement

Normally, there is a written contract that binds the parties. It outlines the terms and conditions based on which the parties will contribute in the arrangement. Most of the times each contractual agreement creates a single joint agreement. However, there may be cases where one master agreement creates several separate joint agreements. The contract, generally, includes matters such as

a. Purpose of the arrangement

b. Duration of the arrangement

c. Scope of activities

d. The way the members of the governing body shall be appointed

e. Contribution of capital by the parties

f. Sharing of assets, liabilities, revenues, expenses, profits or losses.

6.4.2 Joint Control

The control is shared when all the parties involved in the arrangement, considered collectively, can make the relevant decisions of the arrangement.

Illustration 11

Shareholders C and D form a new joint arrangement (entity CD). Entity CD's article of association including a clause stating that all shareholders must unanimously agree on the entity's relevant activities. The shareholders have not entered into any other agreement to manage the activities of entity CD. Determine whether clause in CD's articles of association is sufficient to meet the definition of joint arrangement?

Solution

Entity CD meets the definition of a joint arrangement even though there is no separate joint venture agreement. The clause in entity CD's articles of association is sufficient for meeting the definition of a joint arrangement, provided entity CD's articles of association are legally binding.

*****

Illustration 12: Impact of managing an arrangement

ECL Limited has a wholly owned subsidiary, entity B, that holds a portfolio of buildings. ECL Limited wishes to reduce its exposure to this market. It sells 50% of its investment in entity B to Investment Bank. ECL Limited and Investment Bank enter into a contractual agreement, whereby decisions regarding entity B's relevant activities are made jointly. ECL Limited continues to act as asset manager of entity B for a specified fee, and decisions are made in line with the entity B's pre- approved budgets and business plan. Is entity B jointly controlled?

Solution

Entity B is jointly controlled, as ECL Limited and investment bank are required to agree unanimously on relevant activities, and ECL Limited must manage the entity's operations in line with these decisions.

*****

Illustration 13: Chairman with casting vote

M Limited and N Limited set up a joint venture company, MN Limited, by signing a joint operating agreement. Both investors delegate three directors each to entity MN's board of directors. Decisions are made by simple majority. In the event of a deadlock, the chairman (a director of N Limited) has the casting vote. Does N Limited has control over MN Limited?

Solution

It is likely that N Limited has control over MN Limited, as decisions made on behalf of N Limited cannot be prevented by M Limited.

Once it is established that there is a Joint Arrangement, it is required to classify whether the arrangement is joint venture or joint operation.

*****

6.5 TYPES OF JOINT ARRANGEMENTS

6.5.1 Joint Operations

In case of joint operations, each party (known as "Joint Operators") recognizes its share of assets, liabilities, revenues and expenses of the joint arrangement. Here the contract determines the share of each joint operator based on rights and obligations of each party. The joint operator shall then apply the corresponding IND ASs to the particular asset, liability, revenue and expenses.

It covers all the arrangements that are not structured through separately identifiable financial structure, including separate legal entities ("Separate Vehicle").

For example, two parties may decide to enter into a joint arrangement to manufacture stationery products. Each party has its own set of activities using its own assets. In the process each party will incur its own liabilities. The contract will define the method of sharing the revenues and expenses. Therefore, each joint operator shall record the assets and liabilities used in the arrangement, and recognises its share of the revenues and expenses in accordance with the contractual specifications.

However, Joint operations may also include some joint arrangements which are not structured through separate vehicle depending its structure, the terms of the contractual arrangement; and other facts and circumstances.

Illustration 14 : Joint Operation

Three separate aerospace companies form an alliance to jointly manufacture an aircraft. They carry responsibility for different areas of expertise such as :

- *Manufacturing engines*
- *Manufacturing fuselage and wings; and*
- *Aerodynamics*

They carry out different parts of the manufacturing process, each using its own resources and expertise in order to manufacture, market and distribute the aircraft jointly. The three entities share the revenues from the sale of aircraft and jointly incur expenses. The revenues and common costs are shared, as agreed in the consortium contract.

Parties also incur their own separate costs such as labour costs, manufacturing costs, supplies, inventory of unused parts and work in progress. Each party recognizes its separately incurred costs in full. Would the arrangement be classified as joint operation?

Solution

This arrangement is classified as a joint operation because:

- The arrangement is not structured through a separate vehicle;
- Each party has obligations for the costs it incurs separately; and
- The contractual agreement outlines that each party is entitled to a share of revenue and associated costs from the sale of aircrafts based on the pre-determined agreement.

*****

6.5.2 Joint Ventures

In a joint venture, each party (known as "Joint Venturer") recognizes its interest in a joint venture as an investment. The investment is accounted for using the equity method in accordance with Ind AS 28, Investments in Associates and Joint Ventures, unless the entity is exempted from applying the equity method as specified in that standard.

6.6 CLASSIFICATION OF JOINT ARRANGEMENTS

As stated above, all the joint arrangements which are not structured through separate vehicle are Joint operations.

Further, the arrangements which are structured through separate vehicle can be classified as Joint operation or Joint venture depending on the following:

6.6.1 Structure of the Joint Arrangement

Structure or the legal form of the joint arrangement is important in assessing the type of joint arrangement. It determines the initial assessment of parties' rights to the assets and obligations for the liabilities held in the separate vehicle. The legal form specifies whether the parties have interests in the assets held in the separate vehicle and whether they are liable for the liabilities held in the separate vehicle.

For Example, two parties may conduct a joint arrangement where the assets and liabilities of the separate vehicle are not individually controlled by the parties. Assets and liabilities so held are the assets and liabilities of the separate vehicle. Hence it will be a Joint venture.

If the parties have right to individual assets and obligation for liabilities, then it will be a joint operation.

Illustration 15

Two parties structure a joint arrangement in an incorporated entity. Each party has a 50 per cent ownership interest in the incorporated entity. The incorporation enables the separation of the entity from its owners and as a consequence the assets and liabilities held in the entity are the assets and liabilities of the incorporated entity.

(i) Identify the type of arrangement?

(ii) If the parties modify the features of corporation though a contractual arrangement such that each has an interest in assets and each is liable for liabilities what type of joint arrangement would that be?

Solution

(i) On assessment of the rights and obligations conferred upon the parties by the legal form of the separate vehicle indicates that the parties have rights to the net assets of the arrangement. In this case it would be classified as joint venture.

(ii) If the parties modify the features of the corporation through their contractual arrangement so that each has an interest in the assets of the incorporated entity and each is liable for the liabilities of the incorporated entity in a specified proportion. Such contractual modifications to the features of a corporation can cause an arrangement to be a joint operation.

*****

Illustration 16: Legal form may not provide separation

Entities B and C form a partnership to own and operate a crude oil refinery. Each party has a 50% interest in the net profits of the partnership. What considerations would the management have to consider in classifying the arrangement as joint venture or joint operation?

Solution

The joint arrangement is structured through a vehicle, and the venture parties each have a 50% interest in the net profits of the partnership; so this appears to be a joint venture. However, management needs to evaluate whether the partnership creates separation, that is simply are the assets and liabilities those of the separate vehicle or do the parties have direct rights to the assets and have direct obligations for the liabilities held by the entity . Should the parties to the partnership have a direct interest in the assets and liabilities, this would indicate a joint operation. Management should therefore, evaluate the terms of the partnership agreement to assess the rights and obligations of each party.

*****

6.6.2 Assessing the terms of the contractual arrangement

It is essential to understand the terms of the contractual arrangement in order to classify the joint arrangement. The pertinent questions, to be analysed from the contract, are

a. Do the parties have rights to assets and obligation to liabilities of the joint arrangements?

b. Do the parties share all interests (e.g. rights, title or ownership) in the assets relating to the arrangement in a specified proportion?

c. Do parties share all liabilities, obligations, costs and expenses in a specified proportion?

d. Does the allocation of revenue and expenses are agreed on the basis of the relative performance of each party to the joint arrangement?

If the answer to the above questions is 'yes', then the arrangement shall be classified as joint operation. However, where the parties are sharing net assets in the joint arrangement, the arrangement shall be treated as joint venture.

Illustration 17: Joint Construction and use of a pipeline

Two parties, W and F form a limited company to build and use a pipeline to transport gas. Each party has a 50% interest in the company. Under their contractual terms, entities W and F must each use 50% of the pipeline capacity; unused capacity is charged at the same price as used capacity. Entities W and F can sell their share of the capacity to a third party without consent from both investors. The Price entities W and F pay for the gas transport is determined in a way that ensures all costs incurred by the company can be recovered. The Joint arrangement is structured through a separate vehicle. Each party has a 50% interest in the company. However, the contractual terms require a specific level of usage by each party and, because of the pricing structure, and the entities have an obligation for the company's liabilities. What type of joint arrangement the company might be?

Solution

This entity might be a joint operation despite its legal form.

*****

6.6.3 Assessing other facts and circumstances

When the terms of the contractual arrangement do not specify that the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement, the parties shall consider other facts and circumstances to assess whether the arrangement is a joint operation or a joint venture.

It will then be worthwhile to consider whether the activities of the arrangement primarily aim to provide parties with an output. This indicates that parties shall have rights to all the benefits of the assets of the arrangement. The parties will make sure that the output is not sold to the third parties but used by them only. Such are joint operations.

Illustration 18

Two parties structure a joint arrangement in an incorporated entity (entity D) in which each party has a 50 per cent ownership interest. The purpose of the arrangement is to manufacture materials required by the parties for their own, individual manufacturing processes. The arrangement ensures that the parties operate the facility that produces the materials to the quantity and quality specifications of the parties. The legal form of entity D (an incorporated entity) through which the activities are conducted initially indicates that the assets and liabilities held in entity D are the assets and liabilities of entity D. The contractual arrangement between the parties does not specify that the parties have rights to the assets or obligations for the liabilities of entity D.

(i) What type of joint arrangement would entity D be?

(ii) Would your classification change if the parties instead of using the share of output themselves sold to third parties?

(iii) If the parties changed the terms of contractual arrangement such that entity D would be able to sell the output to third parties, would your answer be the same as in part (i) above?

Solution

(i) The legal form of entity D and the terms of the contractual arrangement indicate that the arrangement is a joint venture.

However, the parties also consider the following aspects of the arrangement:

- The parties agreed to purchase all the output produced by entity D in a ratio of 50 : 50. Entity D cannot sell any of the output to third parties, unless this is approved by the two parties to the arrangement. Because the purpose of the arrangement is to provide the parties with output they require, such sales to third parties are expected to be uncommon and not material.
- The price of the output sold to the parties is set by both parties at a level that is designed to cover the costs of production and administrative expenses incurred by entity D. On the basis of this operating model, the arrangement is intended to operate at a break-even level.

From the fact pattern above, the following facts and circumstances are relevant:

- The obligation of the parties to purchase all the output produced by entity D reflects the exclusive dependence of entity D upon the parties for the generation of cash flows and, thus, the parties have an obligation to fund the settlement of the liabilities of entity D.
- The fact that the parties have rights to all the output produced by entity D means that the parties are consuming, and therefore have rights to, all the economic benefits of the assets of entity D.

These facts and circumstances indicate that the arrangement is a joint operation.

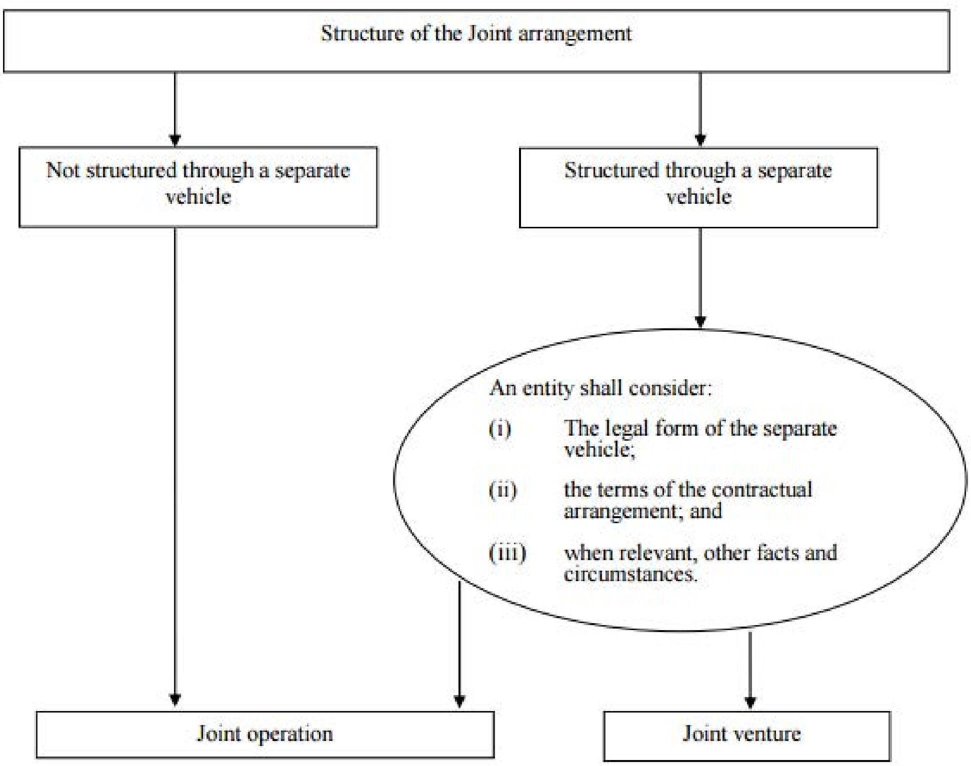
(ii) The conclusion about the classification of the joint arrangement in these circumstances would not change if, instead of the parties using their share of the output themselves in subsequent manufacturing process, the parties sold their share of the output to third parties.

(iii) If the parties changed the terms of the contractual arrangement so that the arrangement was able to sell output to third parties, this would result in entity D assuming demand, inventory and credit risks. In that scenario, such a change in the facts and circumstances would require reassessment of the classification of the joint arrangement. Such facts and circumstances would indicate that the arrangement is a joint venture.

	Conditions	Yes	No
Structure of the joint arrangement	Does the legal form give the parties rights to the assets and obligations for the liabilities relating to the arrangement?	If yes, the joint arrangement is concluded to be a joint operation	If no, obtain more information.

Assessing the terms of the contractual arrangement	Do the terms of the Contractual arrangement specify that the parties have rights to the assets and obligations for the liabilities relating to the arrangement?	If yes, the joint arrangement is concluded to be a joint operation	If no, obtain more information.
Assessing other facts and circumstances	Does the arrangement so designed that its activities mainly provide the parties with an output and so that it depends on the parties on a regular basis for settling the liabilities of the arrangement?	If yes, the joint arrangement is concluded to be a joint operation.	If no, the joint arrangement is a joint venture.

Classification of a joint arrangement: assessment of the parties' rights and obligations arising from the arrangement



6.7 FINANCIAL STATEMENT OF PARTIES TO A JOINT ARRANGEMENT

6.7.1 Joint Operations

It is important for the joint operators to understand and analyse their joint arrangements in detail. Joint operators must ensure that they are aware of all the rights and obligations therein, and the proportion in which they are shared amongst the parties.

For joint operations, a joint operator accounts for the following in accordance with the applicable Ind AS:

I. Its assets, including its share of any assets held jointly

II. Its liabilities, including its share of any liabilities incurred jointly

III. Its revenue from the sale of its share of the output arising from the joint operation

IV. Its share of revenue from the sale of the output by the joint operation

V. Its expenses, including its share of any expenses incurred jointly

Illustration 19

P and Q form a joint arrangement PQ using a separate vehicle. P and Q each own 50% of the Capital in PQ. However, the contractual terms of the joint arrangement state that P has the rights to all of Machinery and the obligation to pay Bank Loan in Q. P and Q have rights to all other assets in PQ, and obligations for all other liabilities in PQ in proportion to their capital share (i.e., 50%).

PQ's balance sheet is as follows: *(in ₹)*

Balance Sheet

Liabilities	*₹*	*Assets*	*₹*
Capital	*1,50,000*	*Machinery*	*2,50,000*
Bank Loan	*75,000*	*Cash*	*50,000*
Other Loan	*75,000*		
	3,00,000		*3,00,000*

What would you record in P's financial statements to account for its rights and obligations in PQ?

Note: *P is not exposed to any variable returns in Q*

Solution

Under Ind AS 111, we would record the following in its financial statements, to account for its rights to the assets in PQ and its obligations for the liabilities in PQ. This may differ from the amounts recorded using proportionate consolidation.

Machinery	250,000

Cash	25,000
Capital	75,000
Bank Loan	75,000
Other Loan	37,500

*****

Illustration 20

AB Limited and BC Limited establish a joint arrangement through a separate vehicle PQR, but the legal form of the separate vehicle does not confer separation between the parties and the separate vehicle itself. Thus, both the parties have rights to the assets and obligations for the liabilities of PQR. As neither the contractual terms nor the other facts and circumstances indicate otherwise, it is concluded that the arrangement is a joint operation and not a joint venture.

Both the parties own 50% each of the equity interest in PQR. However, the contractual terms of the joint arrangement state that AB Limited has the rights to all of Building No. 1 owned by PQR and the obligation to pay all of the debt owed by PQR to a lender XYZ. AB Limited and BC Limited have rights to all other assets in PQR, and obligations for all other liabilities of PQR in proportion of their equity interests (i.e. 50% each).

PQR's balance sheet is as follows (all amounts in INR):

Liabilities and equity	*Amount*	*Assets*	*Amount*
Debt owed to XYZ	*240*	*Cash*	*40*
Employee benefit plan obligation	*100*	*Building 1*	*240*
Equity	*140*	*Building 2*	*200*
Total	*480*	*Total*	*480*

How would AB Limited present its interest in PQR in its financial statements?

Solution

Paragraph 20 of Ind AS 111 states that "a joint operator shall recognise in relation to its interest in a joint operation:

(a) its assets, including its share of any assets held jointly;

(b) its liabilities, including its share of any liabilities incurred jointly;

(c) its revenue from the sale of its share of the output arising from the joint operation;

(d) its share of the revenue from the sale of the output by the joint operation; and

(e) its expenses, including its share of any expenses incurred jointly."

The rights and obligations, as specified in the contractual arrangement, that an entity has with respect to the assets, liabilities, revenue and expenses relating to a joint operation might differ from its ownership interest in the joint operation. Thus a joint operator needs to recognise its interest in the assets, liabilities, revenue and expenses of the joint operation on the basis (bases) specified in the contractual arrangement, rather than in proportion of its ownership interest in the joint operation.

Thus, AB Limited would record the following in its financial statements, to account for its rights to the assets of PQR and its obligations for the liabilities of PQR.

	Amount
Assets	
Cash	20
Building 1*	240
Building 2	100
Liabilities	
Debt (third party)^	240
Employees benefit plan obligation	50

^AB Limited has obligation for the debt owed by PQR to XYZ in its entirety.

*Since AB Limited has the rights to all of Building No. 1, it records the amount in its entirety.

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Illustration 21

Entity X is owned by three institutional investors – A Limited, B Limited and C Limited – holding 40%, 40% and 20% equity interest respectively. A contractual arrangement between A Limited and B Limited gives them joint control over the relevant activities of Entity X. It is determined that Entity X is a joint operation (and not a joint venture). C Limited is not a party to the arrangement between A Limited and B Limited. However, like A Limited and B Limited, C Limited also has rights to the assets, and obligations for the liabilities, relating to the joint operation in proportion of its equity interest in Entity X.

Would the manner of accounting to be followed by A Limited and B Limited on the one hand and C Limited on the other in respect of their respective interests in Entity X be the same or different?

Solution

Paragraphs 26 and 27 of Ind AS 111 state that in its separate financial statements, a joint operator or joint venture shall account for its interest in:

(a) a joint operation in accordance with paragraphs 20–22;

(b) a joint venture in accordance with paragraph 10 of Ind AS 27, *Separate Financial Statements*.

In its separate financial statements, a party that participates in, but does not have joint control of, a joint arrangement shall account for its interest in:

(a) a joint operation in accordance with paragraph 23;

(b) a joint venture in accordance with Ind AS 109, unless the entity has significant influence over the joint venture, in which case it shall apply paragraph 10 of Ind AS 27."

Paragraphs 20 and 21 of Ind AS 111 state that a joint operator shall recognise in relation to its interest in a joint operation:

(a) its assets, including its share of any assets held jointly;

(b) its liabilities, including its share of any liabilities incurred jointly;

(c) its revenue from the sale of its share of the output arising from the joint operation;

(d) its share of the revenue from the sale of the output by the joint operation; and

(e) its expenses, including its share of any expenses incurred jointly.

A joint operator shall account for the assets, liabilities, revenues and expenses relating to its interest in a joint operation in accordance with the Ind ASs applicable to the particular assets, liabilities, revenues and expenses."

Paragraph 23 of Ind AS 111 states that a party that participates in, but does not have joint control of a joint operation shall also account for its interest in the arrangement in accordance with paragraphs 20–22 if that party has rights to the assets, and obligations for the liabilities, relating to the joint operation.

If a party that participates in, but does not have joint control of, a joint operation does not have rights to the assets, and obligations for the liabilities, relating to that joint operation, it shall account for its interest in the joint operation in accordance with the Ind ASs applicable to that interest.

In the given case, all three investors (A Limited, B Limited and C Limited) share in the assets and liabilities of the joint operation in proportion of their respective equity interest. Accordingly, both A Limited and B Limited (which have joint control) and C Limited (which does not have joint control) shall apply paragraphs 20-22 in accounting for their respective interests in Entity X in their respective separate financial statements as well as consolidated financial statements.

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6.7.2 Joint Venture

A joint venturer shall recognise its interest in a joint venture as an investment and shall account for that investment using the equity method in accordance with Ind AS 28, Investments in Associates and Joint Ventures, unless the entity is exempted from applying the equity method as specified in that standard.

A party that participates in, but does not have joint control of, a joint venture shall account for its interest in the arrangement in accordance with Ind AS 109, Financial Instruments, unless it has significant influence over the joint venture, in which case it shall account for it in accordance with Ind AS 28.

UNIT 7 : INVESTMENT IN ASSOCIATES & JOINT VENTURES

7.1 INTRODUCTION

Ind AS 28, Investments in Associates and Joint Ventures,

a) prescribes the accounting for investments in associates and

b) sets out the requirements for the application of the equity method when accounting for investments in associates and joint ventures.

It is important to note here that Ind AS 111, describes joint arrangements including joint ventures and prescribes equity method for joint ventures. But here, in Ind AS 28, the equity method is described for both Associate and Joint Ventures.

7.2 SCOPE

This Standard shall be applied by all entities that are investors with joint control of, or significant influence over, an investee.

7.3 SIGNIFICANT INFLUENCE

The concept of 'significant influence' signifies the close relationship between two entities where one has the power to influence the decision making in the other entity. In today's business world, many companies do not have actual control over other companies but hold significant ownership to influence the decision making in such companies. Many such investments are in the form of joint ventures in which two or more companies form a new entity to carry out a specified operating purpose.

For example, Microsoft and NBC formed MSNBC, a cable channel and online site to go with NBC's broadcast network. Each partner owns 50 percent of the joint venture. For each of these investments, the investors do not possess absolute control because they hold less than a majority of the voting stock. Thus, the preparation of consolidated financial statements is inappropriate. However, the large percentage of ownership indicates that each investor possesses some ability to affect the investee's decision-making process.

Definition

Significant influence is the power to *participate* in the financial and operating policy decisions of the investee but is not control or joint control of those policies.

Analysis

✓ **HOLDING 20% OR MORE OF THE VOTING RIGHTS:** If an entity holds, directly or indirectly (eg through subsidiaries), 20 per cent or more of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case.

✓ **HOLDING LESS THAN 20% OF VOTING RIGHTS:** Also, in cases where the entity holds, directly or indirectly (eg through subsidiaries), less than 20 per cent of the voting power of the investee, it is presumed that the entity does not have significant influence, unless such influence can be clearly demonstrated.

Illustration 1

X Ltd. owns 20% of the voting rights in Y Ltd. and is entitled to appoint one director to the board, which consist of five members. The remaining 80% of the voting rights are held by two entities, each of which is entitled to appoint two directors.

A quorum of four directors and a majority of those present are required to make decisions. The other shareholders frequently call board meeting at the short notice and make decisions in the absence of X Ltd's representative. X Ltd has requested financial information from Y Ltd, but this information has not been provided. X Ltd's representative has attended board meetings, but suggestions for items to be included on the agenda have been ignored and the other directors oppose any suggestions made by X Ltd. Is Y Ltd an associate of X Ltd.?

Solution

Despite the fact that the X Ltd owns 20% of the voting rights and has representations on the board, the existence of other shareholders holding a significant proportion of the voting rights prevent X Ltd. from exerting significant influence. Whilst it appears the X Ltd should have the power to participate in the financial and operating policy decision, the other shareholders prevent X Ltd's efforts and stop X Ltd from actually having any influence.

In this situation, Y Ltd would not be an associate of X Ltd.

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Whether an investor has significant influence over the investee is a matter of judgment based on the nature of the relationship between the investor and the investee. Existence of significant influence may be judged by the following factors:

a) Representation on the board of directors or equivalent governing body of the investee;

Illustration 2

Kuku Ltd. holds 12% of the voting shares in Boho Ltd. Boho Ltd.'s board comprise of eight members and two of these members are appointed by Kuku Ltd. Each board member has one vote at meeting. Is Boho Ltd an associate of Kuku Ltd?

Solution

Boho Ltd is an associate of Kuku Ltd as significant influence is demonstrated by the presence of directors on the board and the relative voting rights at meetings.

It is presumed that entity has significant influence where it holds 20% or more of the voting power of the investee, but it is not necessary to have 20% representation on the board to demonstrate significant influence, as this will depend on all the facts and circumstances. One board member may represent significant influence even if that board member has less than 20% of the voting power. But for significant influence to exist it would be necessary to show based on specific facts and circumstances that this is the case, as significant influence would not be presumed.

*****

b) Participation in policy-making processes, including participation in decisions about dividends or other distributions;

Example:

X Ltd creates a separate legal entity in which it holds less than 20 % of the voting interests but however controls that entity through contracts that ensures that decision-making power and the distribution of profits and losses lies with X ltd. In such cases the investor is able to exercise significant influence over its investee.

Example:

Info Ltd owns 9% equity in Sync Ltd. However, it has the approval or veto rights over critical decisions of compensation, hiring, termination, and other operating and capital spending decisions of Sync Ltd. The non-controlling rights are so restrictive that it is appropriate to infer that control rests with the Info Ltd for all major decisions.

c) Material transactions between the entity and its investee;

Illustration 3

Q Ltd manufactures shoes for a leading retailer P Ltd. P Ltd provides all designs for the shoes and participates in scheduling, timing and quantity of the production. The majority (i.e. 90%) of Q Ltd.'s sales are made to the retailer, P Ltd. P Ltd. has 10% shareholding in the Q Ltd. It acquired this interest many years ago at the start of their relationship. Does significant influence exist?

Solution

Q Ltd is highly dependent on the retailer for the continued existence of the business. Despite having only a 10% interest in Q Ltd, P Ltd has significant influence

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Illustration 4

X Ltd owns 15% of the voting rights of Y Ltd., and the remainder are widely dispersed among the public.

X Ltd also is the only supplier of crucial raw materials to Y Ltd., further it provides certain expertise guidance regarding the maintenance of Y Ltd.'s factory.

Discuss the relationship between X Ltd. and Y Ltd.

Solution

Y Ltd. is effectively functioning because of the participation of X Ltd. in the Y Ltd.'s factory despite having 15% interest in Y Ltd., X Ltd. has significant influence.

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d) Interchange of managerial personnel; or

Illustration 5

Entity X and entity Y, operate in the same industry, but in different geographical regions. Entity X acquires a 10% shareholding in entity Y as a part of a strategic agreement. A new production process is key to serve a fundamental change in the strategic direction of entity Y. The terms of agreement provide for entity Y to start a new production process under the supervision of two managers from entity X. The managers seconded from entity X, one of whom is on entity X's board, will oversee the selection and recruitment of new staff, the purchase of new equipment, the training of the workforce and the negotiation of new purchase contracts for raw materials. The two managers will report directly to entity Y's board as well as to entity X's. Analyse.

Solution

The secondment of the board member and a senior manager from entity X to entity Y gives entity X, a range of power over a new production process and may evidence that entity X has significant influence over entity Y. This assessment take into the account what are the key financial and operating policies of entity Y and the influence this gives entity X over those policies.

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e) Provision of essential technical information.

Illustration 6

Soul Ltd has 18% interest in God Ltd. Soul Ltd manufacture mobile telephone handsets using technology developed by God Ltd. God Ltd licenses the technology to Soul Ltd and updates the license agreement for new technology on a regular basis. The handsets are sold by Soul Ltd and represent substantially Soul Ltd's entire sale. Analyse.

Solution

Soul Ltd is dependent on the technology that God Ltd supplies since a high proportion of Soul Ltd's sales are based on that technology. Therefore, Soul Ltd is likely to be an associate of God Ltd because of the provision of essential technical informational.

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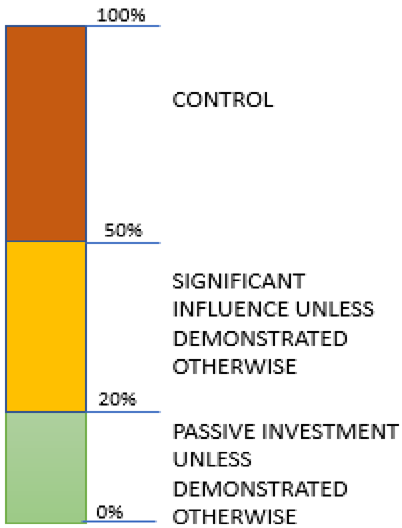
7.4 POTENTIAL VOTING RIGHTS

An investor may hold any instrument (such as share warrants, share call options, debt or equity instruments) issued by an associate and terms of the instrument is that a holder will get an equity rights on the expiry of the term i.e. they are convertible into ordinary shares, to give the entity additional voting power or to reduce another party's voting power over the financial and operating policies of another entity (ie potential voting rights). Only an existing right will be considered for determining the Significant influence. Any potential voting rights that will arise in future will not be considered while determining Significant influence.



It is worth nothing that a substantial or majority ownership by another investor does not necessarily preclude an entity from having significant influence

7.5 EQUITY METHOD

a) **On the date of acquisition:**

Under the equity method, on initial recognition the investment in an associate or a joint venture is recognised at cost.

Investment in Associate A/c	Dr.
To Cash A/c	

b) **Recognizing the share in Profit or loss:**

Since the investor has the significant influence over the investee, the investor has an interest in the performance of the investee. It can influence the dividend to be distributed irrespective of the actuals profits made by the investee. Here the recognition of income based on profit distributed may not be a true measure of the income earned by an investor on an investment in an associate or a joint venture. The distributions made may bear little relation to the actual performance of the associate or joint venture. Hence recognizing actual profit or loss (irrespective of the amount of dividend distributed) is more reflective of the actual value of the investment.

(i) If Associate or joint venture makes profit

Investment in Associate A/c	Dr.
To Share in Profit from Associate A/c	

(ii) If Associate or joint venture makes losses

Share in Losses from Associate A/c	Dr.
To Investment in Associate A/c	

(iii) Cash dividend received: Any distribution of dividend in the form of cash received from the associate reduces the carrying amount of the investment.

Cash A/c	Dr.
To Investment in Associate A/c	

Application of Equity Method

Investee Event	Books of Investor
Income is earned	Proportionate share of income is recognized by investor
Dividends distributed	Investor's share in dividends reduces the investment account

Illustration 7

Amar Ltd. acquires 40% shares of Ram Ltd. On 1 April, 20X1, the price paid is ₹ 10,00,000. Ram Ltd has reported a profit of ₹ 2,00,000 and paid dividend of ₹ 1,00,000. Calculate Carrying Amount of Investment as per Equity Method?

Solution

Cost	10,00,000
Add: Share in Post-Acquisition Profits (2,00,000 x 40%)	80,000
Less: Distribution of Dividend (1,00,000 x 40%)	(40,000)
	10,40,000

Adjustments to the carrying amount may also be necessary for a change in the investor's proportionate interest in the investee arising from changes in the investee's other comprehensive income. Such changes include those arising from the revaluation of property, plant and equipment and from foreign exchange translation differences. The investor's share of those changes is recognised in other comprehensive income of the investor

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7.6 APPLICATION OF EQUITY METHOD

The investor needs to apply equity method of accounting when it has joint control or significant influence over the investee.

The rationale behind the application of the equity method is that in case of an associate or a joint venture, an investor commences to gain the ability to influence the decision-making process of an investee as the level of ownership rises. The investor, hence, has the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50 percent or less of the voting rights. Clearly, this is a subject of judgments and interpretations in practice. Also, it is important to note that 'significant influence' is required to be present but there is no requirement that any actual influence must have ever been applied.

However, the investor is exempt from the application of Equity Method under certain circumstances.

7.6.1 Exemptions from applying the equity method

An entity need not apply the equity method to its investment in an associate or a joint venture if the entity is a parent that is exempt from preparing consolidated financial statements by the scope exception in paragraph 4(a) of Ind AS 110 or if all the following apply:

(a) The entity is a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the entity not applying the equity method.

(b) The entity's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets).

(c) The entity did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation, for the purpose of issuing any class of instruments in a public market.

(d) The ultimate or any intermediate parent of the entity produces consolidated financial statements available for public use that comply with Ind AS.

When an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure investments in those associates and joint ventures at fair value through profit or loss in accordance with Ind AS 109.

When an entity has an investment in an associate, a portion of which is held indirectly through a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure that portion of the investment in the associate at fair value through profit or loss in accordance with Ind AS 109 regardless of whether the venture capital organisation has significant influence over that portion of the investment. If the entity makes that election, the entity shall apply the equity method to any remaining portion of its investment in an associate that is not held through a venture capital organisation.

An entity's net investment in associate or joint venture includes investment in ordinary shares, other interests that are accounted using the equity method, and other long term interests, such as preference shares and long term receivables or loans, the settlement of which is neither planned nor likely to occur in the foreseeable future. These long term interests are not accounted for in accordance with Ind AS 28, instead they are governed by the principles of Ind AS 109.

As per para 10 of Ind AS 28, the carrying amount of entity's investment in its associate and joint venture increases or decreases (as per equity method) to recognise the entity's share of profit or loss of its investee associate and joint venture.

Para 38 of Ind AS 38 further states that the losses that exceed he entity's investment in ordinary shares are applied to other components of the entity's interest in the associate or joint venture in the reverse order of their superiority.

In this context, the amendments to Ind AS 28 clarify that the accounting for losses allocated to long-term interests would involve the dual application of Ind AS 28 and Ind AS 109. The annual sequence in which both standards are to be applied can be explained in a three step process:

<u>Step 1: Apply Ind AS 109 independently</u>

Apply Ind AS 109 (such as impairment, fair value adjustments etc.) ignoring any adjustments to carrying amount of long-term interests under Ind AS 28 (such as allocation of losses, impairment etc.)

<u>Step 2: True-up past allocations</u>

If necessary, prior years' Ind AS 28 loss allocation is trued up in the current year, because Ind AS 109 carrying value may have changed. This may involve recognizing more prior year's losses, reversing these losses or re-allocating them between different long-term interests.

<u>Step 3: Book current year equity share</u>

Any current year Ind AS 28 losses are allocated to the extent that the remaining long-term interest balance allows. Any current year Ind AS 28 profits reverse any unrecognized prior years' losses and then allocations are made against long-term interests.

7.6.2 Discontinuing of equity Method

The investor should discontinue the use of Equity Method from the date the significant influence or joint control ceases.

7.6.3 Equity method procedures

While preparing the consolidated financial statements, an investor applies equity method of accounting for investments in associates and joint ventures. It includes the aggregate of the holdings in that associate or joint venture by the parent and its subsidiaries taken together. The holdings of the group's other associates or joint ventures are ignored for this purpose.

When an associate or a joint venture has subsidiaries, associates or joint ventures, the profit or loss, other comprehensive income and net assets taken into account in applying the equity method are those recognised in the associate's or joint venture's financial statements (including the associate's or joint venture's share of the profit or loss, other comprehensive income and net assets of its associates and joint ventures), after any adjustments necessary to give effect to uniform accounting policies.

In accounting, transactions between related companies are identified as either downstream or upstream. Downstream transfers include investor's sale of an item to investee. Conversely, a downstream transfer means sales made by investee to investor. These two types of intra entity transactions are examined separately.

Gains and losses resulting from 'upstream' and 'downstream' transactions between an entity (including its consolidated subsidiaries) and its associate or joint venture are recognised in the entity's financial statements only to the extent of unrelated investors' interests in the associate or joint venture. The investor's share in the associate's or joint venture's gains or losses resulting from these transactions is eliminated.

Example:

Assume that Babu Ltd owns a 40% share of Sahu Ltd and accounts for this investment through the equity method. In 20X1, Babu Ltd sells inventory to Sahu Ltd at a price of 50,000. This figure includes a gross profit of 30%.

By the end of 20X1, Sahu Ltd has sold 40,000 of these goods to outside parties while retaining 10,000 in inventory for sale during the subsequent year.

The investor has made downstream sales to the investee. In applying the equity method, recognition of the related profit must be delayed until the buyer disposes of these goods.

Although total intra-entity transfers amounted to 50,000, only 40,000 of this merchandise has already been resold to outsiders, thereby justifying the normal reporting of profits.

For the 10,000 still in the investee's inventory, the earning process is not finished. In computing equity income, this portion of the intra-entity profit must be deferred until Sahu Ltd. disposes of the goods.

The gross profit on the original sale was 30% of the transfer price; therefore, Sahu Ltd.'s profit associated with these remaining items is 3,000 (10,000 * 30%). However, because only 40%

of the investee's stock is held by Babu Ltd., just 1,200 (3,000 * 40%) of this profit is unearned. Babu Ltd's ownership percentage reflects the intra-entity portion of the profit. The total 3,000 gross profit within the ending inventory balance is not the amount deferred. Rather, 40 % of that gross profit is viewed as the currently unrealized figure.

After calculating the appropriate deferral, the investor decreases current equity income by 1,200 to reflect the unearned portion of the intra-entity profit. This procedure temporarily removes this portion of the profit from the investor's books in 20X1 until the investee disposes of the inventory in 20X2.

In the subsequent year, when this inventory is eventually consumed by Sahu Ltd. or sold to unrelated parties, the deferral is no longer needed. The earning process is complete, and Babu Ltd. should recognize the 1,200.

Example: Equity method accounting

B Ltd acquired a 30% interest in D Ltd and achieved significant influence. The cost of the investment was ₹ 2,50,000. The associate has net assets of ₹ 5,00,000 at the date of acquisition. The fair value of those net assets is ₹ 6,00,000 as a fair value of property, plant & equipment is ₹ 1,00,000 higher than its book value. This property, plant & equipment has a remaining useful life of 10 years.

After acquisition D Ltd recognize profit after tax of ₹ 1,00,000 and paid a dividend out of these profits of ₹ 9,000. D Ltd has also recognized exchange losses of ₹ 20,000 directly in other comprehensive income.

B Ltd's interest in D Ltd at the end the year is calculated as follows:	₹
Balance on requisition under the equity method (including goodwill of ₹ 70,000)	
(₹ 2,50,000 – (30% x ₹ 6,00,000))	2,50,000
B Ltd's share of D Ltd's after tax profit (30% x ₹1,00,000)	30,000
Elimination of dividend received by B Ltd from D Ltd (30% x ₹9,000)	(2,700)
B Ltd's share of D Ltd's exchange differences (30% x ₹20,000)	(6,000)
B Ltd's share of amortisation of fair value uplift (30% x ₹10,000)	(3,000)
B Ltd's interest in D Ltd at the end of the year under the equity method (including goodwill)	2,68,300

D Ltd has net assets at the end of the year of ₹ 5,71,000 (that is, net assets at the start of the year of ₹ 5,00,000 , plus profit during the year of ₹ 1,00,000 , less dividend of ₹ 9,000 , less foreign exchange losses of ₹ 20,000).

B Ltd's interest in D Ltd at the end of the year is made up of:	
B Ltd's share of D Ltd.'s net assets (30% x ₹ 5,71,000)	1,71,300
Goodwill	70,000
B Ltd's share of D Ltd's fair value adjustments (the initial fair value	

difference of ₹ 1,00,000 has been reduced by ₹10,000 due to depreciation in the year) (30% x ₹ 90,000)	27,000
B Ltd's interest in D Ltd	2,68,300

Illustration 8

Entity A holds a 20% equity interest in Entity B (an associate) that in turn has a 100% equity interest in Entity C. Entity B recognised net assets relating to Entity C of ₹1,000 in its consolidated financial statements. Entity B sells 20% of its interest in Entity C to a third party (a non-controlling shareholder) for ₹300 and recognises this transaction as an equity transaction in accordance with paragraph 23 of Ind AS 110, resulting in a credit in Entity B's equity of ₹100.

The financial statements of Entity A and Entity B are summarised as follows before and after the transaction:

Before			
A's consolidated financial statements			
Assets	₹	Liabilities	₹
Investment in B	200	Equity	200
Total	200	Total	200
B's consolidated financial statements			
Assets	₹	Liabilities	₹
Assets (from C)	1000	Equity	1000
Total	1000	Total	1000

The financial statements of B after the transaction are summarised below:

After				
B's consolidated financial statements				
Assets	₹	Liabilities	₹	
Assets (from C)	1000	Equity	1000	
Cash	300	Equity transaction with non-controlling interest	100	
		Equity attributable to owners		1100
		Non-controlling interest		200
Total	1300	Total		1300

Although Entity A did not participate in the transaction, Entity A's share of net assets in Entity B increased as a result of the sale of B's 20% interest in C. Effectively, A's share in B's net assets is now ₹ 220 (20% of ₹ 1,100) i.e., ₹ 20 in addition to its previous share.

How is an equity transaction that is recognised in the financial statements of Entity B reflected in the consolidated financial statements of Entity A that uses the equity method to account for its investment in Entity B?

Solution

Ind AS 28 defines the equity method as "a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income."

Paragraph 27 of Ind AS 28, states, inter alia, that when an associate or joint venture has subsidiaries, associates or joint ventures, the profit or loss, other comprehensive income, and net assets taken into account in applying the equity method are those recognised in the associate's or joint venture's financial statements (including the associate's or joint venture's share of the profit or loss, other comprehensive income and net assets of its associates and joint ventures), after any adjustments necessary to give effect to uniform accounting policies.

The change of interest in the net assets / equity of the associate as a result of the investee's equity transaction is reflected in the investor's financial statements as 'share of other changes in equity of investee' (in the statement of changes in equity) instead of gain in Statement of profit and loss, since it reflects the post-acquisition change in the net assets of the investee as per paragraph 3 of Ind AS 28 and also faithfully reflects the investor's share of the associate's transaction as presented in the associate's consolidated financial statements.

Thus, in the given case, Entity A recognises ₹ 20 as change in other equity instead of in statement of profit and loss and maintains the same classification as of its associate, Entity B, i.e., a direct credit to equity as in its consolidated financial statements.

*****

7.6.4 Impairment losses

After application of the equity method, it is necessary to recognise any additional impairment loss with respect to Investor's net investment in the associate or joint venture. There has to be substantial objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the net investment (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows from the net investment that can be reliably estimated. There may be combined multiple events that may result in impairment. It is important to note that any losses expected from future events, no matter how likely, are not recognized. Objective evidences may include

(a) significant financial difficulty of the associate or joint venture;

(b) a breach of contract, such as a default or delinquency in payments by the associate or joint venture;

(c) the entity, for economic or legal reasons relating to its associate's or joint venture's financial difficulty, granting to the associate or joint venture a concession that the entity would not otherwise consider;

(d) it becoming probable that the associate or joint venture will enter bankruptcy or other financial reorganisation; or

(e) the disappearance of an active market for the net investment because of financial difficulties of the associate or joint venture.

Example:

X Ltd, an associate of Y Ltd, disappears from the active market as its financial instruments are no longer publicly traded. However, this is not evidence of impairment. It has to supported by other evidences.

Example:

There is a downgrade of an associate's or joint venture's credit rating. This, however, is not an evidence of impairment, although it may be evidence of impairment when considered with other available information.

Example:

There are significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the associate or joint venture operates, and indicates that the cost of the investment in the equity instrument may not be recovered. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment.

Goodwill that forms part of the carrying amount of the net investment in an associate or a joint venture is not separately recognized. Therefore, it is not tested for impairment separately by applying the requirements for impairment testing goodwill in Ind AS 36, Impairment of Assets. Instead, the entire carrying amount of the investment is tested for impairment in accordance with Ind AS 36 as a single asset, by comparing its recoverable amount (higher of value in use and fair value less costs to sell) with its carrying amount. Accordingly, any reversal of that impairment loss is recognised in accordance with Ind AS 36 to the extent that the recoverable amount of the net investment subsequently increases.

In determining the value in use of the net investment, an entity estimates:

(a) its share of the present value of the estimated future cash flows expected to be generated by the associate or joint venture, including the cash flows from the operations of the associate or joint venture and the proceeds from the ultimate disposal of the investment;

or

(b) the present value of the estimated future cash flows expected to arise from dividends to be received from the investment and from its ultimate disposal.

Using appropriate assumptions, both methods give the same result.

UNIT 8 : DISCLOSURES

8.1 IN SEPARATE FINANCIAL STATEMENTS

i. Disclosures will be as per all applicable Ind AS

ii. When parent elects not to prepare consolidated financial statements and prepares separate financial statements:

   a. Fact that financial statement is a separate financial statement

   b. Exemption from consolidation used: entity have to disclose about exemption from consolidation

   c. Name & place of business (country of incorporation, if different) of entity those CFS is produced for public use & where those CFS are obtainable: If entity produce any CFS to pubic use those CFS are prepare as per Ind AS

   d. List of significant investment in subsidiaries, JV & associates containing details regarding investee

      i. Name

      ii. Principal place of business (country of incorporation, if different)

      iii. Proportion of ownership interest held

   e. Method used for accounting

iii. Parent (i.e. an investment entity) prepare separate financial statement as its only financial statement:

   a. Fact that financial statement is its only financial statement

   b. Disclosures as per Ind AS 112

iv. Entity other than above:

   a. Fact that financial statement is a separate financial statement

   b. List of significant investment in subsidiaries, JV & associates containing details regarding investee

      i. Name

      ii. Principal place of business (country of incorporation, if different)

      iii. Proportion of ownership interest held

   c. Method used for accounting

8.2 IN CONSOLIDATED FINANCIAL STATEMENT

i. The significant judgments and assumptions entity has made in determining:

a. Nature of its interest in another entity or arrangement;

b. Type of joint arrangement in which it has an invested;

c. That it meets the definition of an investment entity

ii. Information about its interests in:

a. subsidiaries

b. arrangements and associates

c. structured entities that are not controlled by the entity

iii. Investment entity status:

a. Change of status

b. Reason

c. Effect of change on financial statement:

   i. Total fair value of subsidiaries ceases to be consolidated

   ii. Total gain or loss

   iii. Line item in Profit or loss

iv. Interest in subsidiaries:

a. Information that enable users to understand:

   i. Composition of group

   ii. Interest that non controlling Interests have in group activities & cash flows that are material including:

      1. Name of subsidiary

      2. Principal place of business (country of Incorporation if different)

      3. Proportion of ownership Interest (voting rights proportion, if different)

      4. Profit & Loss allocated

      5. Accumulated Non controlling interest

      6. Summarized financial information about the subsidiary

b. Information to enable user to evaluate:

   i. Nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group including:

      1. To transfer cash or other assets

2. guarantees or other requirements or loans and advances being made or repaid
3. the nature and extent to which protective rights of non-controlling interests can significantly restrict the entity right
4. Carrying amount of assets & liabilities in CFS on which restriction applies

ii. Nature of and changes in, the risks associated with its interests in consolidated structured entities including:

1. Terms of contractual arrangement-that require to provide financial support
2. Events & circumstances that could expose to risk
3. Provided any financial support:
    a. Type & amount of support
    b. Reason of support
4. Provided any support to previously unconsolidated structured entity, result in controlling:
    a. Reason of support
5. Intention of support or assist

iii. the consequences of changes in its ownership interest (no loss of control):

1. Schedule to show the effect of equity attributable

iv. the consequences of losing control of a subsidiary:

1. Gain or loss & line item in profit or loss
2. Gain or loss attributable to FV of investment in Subsidiary

c. Financial statement of subsidiary is of a different date:

i. End of reporting period date of the subsidiary

ii. Reason for using different date

v. Interest in unconsolidated Subsidiaries (by investment entities):

For each unconsolidated subsidiaries

a. Subsidiary name

b. Principal place of business (country of incorporation, if different)

c. Proportion of ownership interest

d. Financial statement of subsidiary & its parent

e. Significant restriction on the ability of an unconsolidated subsidiary:

i. Transfer fund (in form of cash dividends)

ii. Repay loans & advances

f. Current commitments or intention to provide support or assistance

g. Provided any financial support:

   i. Type & amount of support

   ii. Reason of support

h. Provided any support to previously unconsolidated structured entity, result in controlling:

   i. Reason of support

i. Terms of contractual arrangement-that require to provide financial support

j. Events & circumstances that could expose to risk

vi. Interest in joint arrangements & associates:

a. For nature, extent & financial effect: (for material joint arrangement & associates)

   i. Name of joint arrangement or associate

   ii. Nature of relationship

   iii. Principal place of business (country of incorporation, if different)

   iv. Proportion of ownership interest

   v. Investment measured using Equity method or FV

   vi. Summarized Financial information

   vii. Investment valued using equity method-Then FV

   viii. Financial information in aggregate for all individually immaterial:

      i. Joint ventures

      ii. Associates

   ix. Significant restriction on the ability of joint ventures or associates:

      i. Transfer fund (in form of cash dividends)

      ii. Repay loans & advances

   x. Financial statement used in applying equity method are of different date:

      i. Reporting period end date

      ii. Reason of different date

   xi. Unrecognized share of losses of JV or associate (stop recognizing loss when applying equity method)

b. Risk associated:

   i. Commitments

   ii. Contingent liabilities incurred relating to interest in Joint ventures or associates

vii. Interest in Unconsolidated structured entities:

a. Nature, extent: exposure of risk

b. Information to enable user to evaluate the nature of and changes in the risk

c. Qualitative & quantitative Information about unconsolidated structured entities

d. Information about sponsored entities:

    a. How it has determined-which entity to sponsored

    b. Income from that entities

    c. Carrying amount of all assets transfer to those entities

e. Information in tabular format

f. Carrying amount of asset & liabilities of those entities, recongnised in financial & line item in BS statement

g. Amount represent maximum loss & how it determined & if not determined then reason

h. Comparison of above loss with carrying amount of assets & liabilities recongnised

i. Current intention to provide support or assistance

j. Provide any financial support:

    a. Type & amount of support

    b. Reason of support

viii. Summarized financial Information for subsidiaries, Joint ventures & associates:

a. Subsidiary that has non-controlling interest that are material:

    i. Dividends paid

    ii. Financial information about asset, liability, profit or loss, cash flow (before intercompany elimination)

b. Joint ventures and associate that are material:

    i. Dividend received

    ii. Financial information about asset, liability, profit or loss, cash flow

c. Joint Venture that are material:-

    i. Cash & cash equivalent

    ii. Current financial liability (excluding trade, trade payables, provisions)

    iii. Non Current financial liabilities (excluding trade, trade payables, provisions)

    iv. Depreciation & amortization

    v. Interest income & expenses

    vi. Income tax expenses

d. If entity uses equity method to account for Jv or associates interest:-

   i. Ind AS financial statement of JV or associates should be adjusted (FV adjustment)

   ii. Reconciliation of adjustment

   iii. But above disclosures are not required if:-

      i. FV measured as per Ind AS 28;

      ii. JV or associate does not prepare Ind AS financial statement

TEST YOUR KNOWLEDGE

Questions

1. DEF Ltd. acquired 100% ordinary shares of ₹ 100 each of XYZ Ltd. on 1st October 20X1. On March 31, 20X2 the summarised Balance Sheets of the two companies were as given below:

	DEF Ltd.	XYZ Ltd.
Assets		
Property Plant Equipment		
Land & Buildings	15,00,000	18,00,000
Plant & Machinery	24,00,000	13,50,000
Investment in XYZ Ltd.	34,00,000	-
Inventory	12,00,000	3,64,000
Financial Assets		
Trade Receivable	5,98,000	4,00,000
Cash	1,45,000	80,000
Total	**92,43,000**	**39,94,000**
Equities & Liabilities		
Equity Capital (Shares of ₹ 100 each fully paid)	50,00,000	20,00,000
Other Equity		
Other reserves	24,00,000	10,00,000
Retained Earnings	5,72,000	8,20,000
Financial Liabilities		
Bank Overdraft	8,00,000	-
Trade Payable	4,71,000	1,74,000
Total	**92,43,000**	**39,94,000**

The retained earnings of XYZ Ltd. showed a credit balance of ₹ 3,00,000 on 1st April 20X1 out of which a dividend of 10% was paid on 1st November; DEF Ltd. has recognised the dividend received to profit or loss account; Fair Value of P& M as on 1st October 20X1 was ₹ 20,00,000. The rate of depreciation on plant & machinery is 10%.

Following are the increases on comparison of Fair value as per respective Ind AS with Book value as on 1st October 20X1 which are to be considered while consolidating the Balance Sheets.

Liabilities	Amount	Assets	Amount
Trade Payables	1,00,000	Land & Buildings	10,00,000
		Inventories	1,50,000

Note:

1. It may be assumed that the inventory is still unsold on balance sheet date and the Trade Payables are also not yet settled.
2. Also assume that the Other Reserves of both the companies as on 31st March 20X2 are the same as was on 1st April 20X1.
3. All fair value adjustments have not yet started impacting consolidated post-acquisition profits.

Prepare consolidated Balance Sheet as on March 31, 20X2.

2. Ram Ltd. acquired 60% ordinary shares of ₹ 100 each of Krishan Ltd. on 1st October 20X1. On March 31, 20X2 the summarised Balance Sheets of the two companies were as given below:

	Ram Ltd.	Krishan Ltd.
Assets		
Property, Plant and Equipment		
Land & Buildings	3,00,000	3,60,000
Plant & Machinery	4,80,000	2,70,000
Investment in Krishan Ltd.	8,00,000	-
Inventory	2,40,000	72,800
Financial Assets		
Trade Receivables	1,19,600	80,000
Cash	29,000	16,000
Total	**19,68,600**	**7,98,800**
Equity & Liabilities		
Equity Capital (Shares of ₹ 100 each fully paid)	10,00,000	4,00,000
Other Equity		
Other Reserves	6,00,000	2,00,000
Retained earnings	1,14,400	1,64,000
Financial Liabilities		
Bank Overdraft	1,60,000	-
Trade Payable	94,200	34,800
Total	**19,68,600**	**7,98,800**

The Retained earnings of Krishan Ltd. showed a credit balance of ₹ 60,000 on 1st April 20X1 out of which a dividend of 10% was paid on 1st November; Ram Ltd. has credited the dividend received to its Retained earnings; Fair Value of P& M as on 1st October 20X1 was ₹ 4,00,000; The rate of depreciation on plant & machinery is 10%.

Following are the increases on comparison of Fair value as per respective Ind AS with book value as on 1st October 20X1 which are to be considered while consolidating the Balance Sheets.

Liabilities	Amount	Assets	Amount
Trade Payables	20,000	Land & Buildings	2,00,000
		Inventories	30,000

Note:

1. It may be assumed that the inventory is still unsold on balance sheet date and the Trade Payables are also not yet settled.
2. Also assume that the Other Reserves as on 31st March 20X2 are the same as was on 1st April 20X1.

Prepare consolidated Balance Sheet as on March 31, 20X2.

3. On 31 March 20X2, Blue Heavens Ltd. acquired 100% ordinary shares carrying voting rights of Orange County Ltd. for ₹ 6,000 lakh in cash and it controlled Orange County Ltd. from that date. The acquisition-date statements of financial position of Blue Heavens Ltd. and Orange County Ltd. and the fair values of the assets and liabilities recognised on Orange County Ltd. statement of financial position were:

	Blue Heavens Ltd.	Orange County Ltd.	
	Carrying Amount (₹ in lakh)	Carrying Amount (₹ in lakh)	Fair Value (₹ in lakh)
Assets			
Non-current assets			
Building and other PPE	7,000	3,000	3,300
Investment in Orange County Ltd.	6,000		
Current assets			
Inventories	700	500	600
Trade receivables	300	250	250
Cash	1,500	700	700
Total assets	15,500	4,450	

Equity and liabilities			
Equity			
Share capital	5,000	2,000	
Retained earnings	10,200	2,300	
Current liabilities			
Trade payables	300	150	150
Total liabilities and equity	**15,500**	**4,450**	

Prepare the Consolidated Balance Sheet as on March 31, 20X2 of group of entities Blue Heavens Ltd. and Orange County Ltd.

4. The facts are the same as in Question 3 above. However, Blue Heavens Ltd. acquires only 75% of the ordinary shares, to which voting rights are attached of Orange County Ltd. Blue Heavens Ltd. pays ₹ 4,500 lakhs for the shares. Prepare the Consolidated Balance Sheet as on March 31, 20X2 of group of entities Blue Heavens Ltd. and Orange County Ltd.

5. Facts are same as in Question 3 & 4, Blue Heavens Ltd. acquires 75% of Orange County Ltd. Blue Heavens Ltd. pays ₹ 4,500 lakhs for the shares. At 31 March 20X3, i.e one year after Blue Heavens Ltd. acquired Orange County Ltd., the individual statements of financial position and statements of comprehensive income of Blue Heavens Ltd. and Orange County Ltd. are:

	Blue Heavens Ltd. Carrying Amount (₹ in lakh)	Orange County Ltd. Carrying Amount (₹ in lakh)
Assets		
Non-current assets		
PPE (Building and others)	6,500	2,750
Investment in Orange County Ltd.	4,500	
	11,000	2,750
Current assets		
Inventories	800	550
Financial Asset -Trade receivables	380	300
Cash	4,170	1,420
	5,350	2,270
Total assets	**16,350**	**5,020**
Equity and liabilities		
Equity		
Share capital	5,000	2,000

Retained earnings	11,000	2,850
	16,000	4,850
Current liabilities		
Financial Liabilities-Trade payables	350	170
	350	170
Total liabilities and equity	**16,350**	**5,020**

Statements of Profit and Loss for the year ended 31 March 20X3:

	Blue Heavens Ltd. Carrying Amount (₹ in lakh)	Orange County Ltd. Carrying Amount (₹ in lakh)
Revenue	3,000	1,900
Cost of sales	(1,800)	(1,000)
Administrative expenses	(400)	(350)
Profit for the year	**800**	**550**

Note: Blue Heavens Ltd. estimates that goodwill has impaired by 98. The fair value adjustment to buildings and other PPE is in respect of a building; all buildings have an estimated remaining useful life of 20 years from 31 March 20X2 and estimated residual values of zero. Blue Heavens Ltd. uses the straight-line method for depreciation of PPE. All the inventory held by Orange County Ltd. at 31 March 20X2 was sold during 20X3.

Prepare the Consolidated Balance Sheet as on March 31, 20X3 of group of entities Blue Heavens Ltd. and Orange County Ltd.

6. P Pvt. Ltd. has a number of wholly-owned subsidiaries including S Pvt. Ltd. at 31st March 20X2. P Pvt. Ltd. consolidated statement of financial position and the group carrying amount of S Pvt. Ltd. assets and liabilities (ie the amount included in that consolidated statement of financial position in respect of S Pvt. Ltd. assets and liabilities) at 31st March 20X2 are as follows:

Particulars	Consolidated (₹ in millions)	Group carrying amount of S Pvt. Ltd. asset and liabilities Ltd. (₹ in millions)
Assets		
Non-Current Assets		
Goodwill	380	180
Buildings	3,240	1,340
Current Assets		
Inventories	140	40
Trade Receivables	1,700	900

Cash	3,100	1000
Total Assets	**8,560**	**3,460**
Equities & Liabilities		
Equity		
Share Capital	1600	
Other Equity		
Retained Earnings	4,260	
Current liabilities		
Trade Payables	2,700	900
Total Equity & Liabilities	**8,560**	**900**

Prepare consolidated Balance Sheet after disposal as on 31st March, 20X2 when P Pvt. Ltd. group sold 100% shares of S Pvt. Ltd. to independent party for ₹ 3,000 millions.

7. Reliance Ltd. has a number of wholly-owned subsidiaries including Reliance Jio Infocomm Ltd. at 31st March 20X2.

Reliance Ltd. consolidated statement of financial position and the group carrying amount of Reliance Jio Infocomm Ltd. assets and liabilities (ie the amount included in that consolidated statement of financial position in respect of Reliance Jio Infocomm Ltd. assets and liabilities) at 31st March 20X2 are as follows:

Particulars	**Consolidated (₹ In '000)**	**Group carrying amount of Reliance Jio Infocomm Ltd. asset and liabilities Ltd. (₹ In '000)**
Assets		
Non-current Assets		
Goodwill	190	90
Buildings	1,620	670
Current Assets		
Inventories	70	20
Financial Assets		
Trade Receivables	850	450
Cash	1,550	500
Total Assets	**4,280**	**1,730**
Equity & Liabilities		
Equity		
Share Capital	800	
Other Equity		

Retained Earnings	2,130	
	2,930	
Current liabilities		
Financial liabilities		
Trade Payables	1,350	450
Total Equity & Liabilities	**4,280**	**450**

Prepare consolidated Balance Sheet after disposal as on 31st March, 20X2 when Reliance Ltd. group sold 90% shares of Reliance Jio Infocomm Ltd. to independent party for ₹ 1000 thousand.

8. Airtel Telecommunications Ltd. owns 100% share capital of Airtel Infrastructures Pvt. Ltd. On 1 April 20X1 Airtel Telecommunications Ltd. acquired a building from Airtel Infrastructures Pvt. Ltd., for ₹ 11,00,000 that the group plans to use as its new headquarters office.

   Airtel Infrastructures Pvt. Ltd. had purchased the building from a third party on 1 April 20X0 for ₹ 10,25,000. At that time the building was assessed to have a useful life of 21 years and a residual value of ₹ 5,00,000. On 1 April 20X1 the carrying amount of the building was ₹ 10,00,000 in Airtel Infrastructures Pvt. Ltd.'s individual accounting records.

   The estimated remaining useful life of the building measured from 1 April 20X1 is 20 years and the residual value of the building is now estimated at ₹ 3,50,000. The method of depreciation is straight-line.

   Pass necessary accounting entries in individual and consolidation situations.

9. As at the beginning of its current financial year, AB Limited holds 90% equity interest in BC Limited. During the financial year, AB Limited sells 70% of its equity interest in BC Limited to PQR Limited for a total consideration of ₹ 56 crore and consequently loses control of BC Limited. At the date of disposal, fair value of the 20% interest retained by AB Limited is ₹ 16 crore and the net assets of BC Limited are fair valued at ₹ 60 crore.

   These net assets include the following:

   (a) Debt investments classified as fair value through other comprehensive income (FVOCI) of ₹ 12 crore and related FVOCI reserve of ₹ 6 crore.

   (b) Net defined benefit liability of ₹ 6 crore that has resulted in a reserve relating to net measurement losses of ₹ 3 crore.

   (c) Equity investments (considered not held for trading) of ₹ 10 crore for which irrevocable option of recognising the changes in fair value in FVOCI has been availed and related FVOCI reserve of ₹ 4 crore.

   (d) Net assets of a foreign operation of ₹ 20 crore and related foreign currency translation reserve of ₹ 8 crore.

   In consolidated financial statements of AB Limited, 90% of the above reserves were included in equivalent equity reserve balances, with the 10% attributable to the non-controlling interest included as part of the carrying amount of the non-controlling interest.

What would be the accounting treatment on loss of control in the consolidated financial statements of AB Limited?

Answers

1 **Consolidated Balance Sheet of DEF Ltd. and its subsidiary, XYZ Ltd. as on 31st March, 20X2**

Particulars	Note No.	₹
I. Assets		
(1) Non-current assets		
(i) Property Plant & Equipment	1	86,00,000
(2) Current Assets		
(i) Inventories	2	17,14,000
(ii) Financial Assets		
(a) Trade Receivables	3	9,98,000
(b) Cash & Cash equivalents	4	2,25,000
Total Assets		**1,15,37,000**
II. Equity and Liabilities		
(1) Equity		
(i) Equity Share Capital	5	50,00,000
(ii) Other Equity	6	49,92,000
(2) Current Liabilities		
(i) Financial Liabilities		
(a) Trade Payables	7	7,45,000
(b) Short term borrowings	8	8,00,000
Total Equity & Liabilities		**1,15,37,000**

Notes to Accounts

			₹
1.	**Property Plant & Equipment**		
	Land & Building	43,00,000	
	Plant & Machinery	43,00,000	86,00,000
2.	**Inventories**		
	DEF Ltd.	12,00,000	
	XYZ Ltd.	5,14,000	17,14,000

3.	**Trade Receivables**		
	DEF Ltd.	5,98,000	
	XYZ Ltd.	4,00,000	9,98,000
4.	**Cash & Cash equivalents**		
	DEF Ltd.	1,45,000	
	XYZ Ltd.	80,000	2,25,000
7.	**Trade payable**		
	DEF Ltd.	4,71,000	
	XYZ Ltd.	2,74,000	7,45,000
8.	**Shorter-term borrowings**		
	Bank overdraft		8,00,000

Statement of Changes in Equity:

5. Equity share Capital

Balance at the beginning of the reporting period	Changes in Equity share capital during the year	Balance at the end of the reporting period
50,00,000	0	50,00,000

6. Other Equity

	Share application money pending allotment	Equity component of compound financial instrument	Reserves & Surplus			Total
			Capital reserve	Retained Earnings	Other Reserves	
Balance at the beginning				0	24,00,000	24,00,000
Total comprehensive income for the year			0	5,72,000		5,72,000
Dividends			0	(2,00,000)		(2,00,000)
Total comprehensive income						

attributable to parent			0	3,35,000		3,35,000
Gain on Bargain purchase			18,85,000			18,85,000
Balance at the end of reporting period			18,85,000	7,07,000	24,00,000	49,92,000

It is assumed that there exists no clear evidence for classifying the acquisition of the subsidiary as a bargain purchase and, hence, the bargain purchase gain has been recognised directly in capital reserve. If, however, there exists such a clear evidence, the bargain purchase gain would be recognised in other comprehensive income and then accumulated in capital reserve. In both the cases, closing balance of capital reserve will be ₹ 18,85,000.

Working Notes:

1. Adjustments of Fair Value

The Plant & Machinery of XYZ Ltd. would stand in the books at ₹ 14,25,000 on 1st October, 20X1, considering only six months' depreciation on ₹ 15,00,000 total depreciation being ₹ 1,50,000. The value put on the assets being ₹ 20,00,000 there is an appreciation to the extent of ₹ 5,75,000.

2. Acquisition date profits of XYZ Ltd. ₹

Reserves on 1.4. 20X1		10,00,000
Profit & Loss Account Balance on 1.4. 20X1		3,00,000
Profit for 20X2: Total ₹ 8,20,000 less ₹ 1,00,000 (3,00,000 – 2,00,000) i.e. ₹ 7,20,000; for 6 months ie. upto 1.10.20X1		3,60,000
Total Appreciation including machinery appreciation (10,00,000 1,50,000 + 5,75,000 – 1,00,000)		16,25,000
Share of DEF Ltd.		32,85,000

3. Post-acquisition profits of XYZ Ltd. ₹

Profit after 1.10. 20X1 [8,20,000-1,00,000]x 6/12	3,60,000
Less: 10% depreciation on ₹ 20,00,000 for 6 months less depreciation already charged for 2nd half of 20X1-20X2 on ₹ 15,00,000 (1,00,000-75,000)	(25,000)
Share of DEF Ltd.	3,35,000

4. Consolidated total comprehensive income ₹

DEF Ltd.	
Retained earnings on 31.3.20X2	5,72,000
Less: Retained earnings as on 1.4.20X1	(0)
Profits for the year 20X1-20X2	5,72,000
Less: Elimination of intra-group dividend	(2,00,000)
Adjusted profit for the year	3,72,000
XYZ Ltd.	
Adjusted profit attributable to DEF Ltd. (W.N.3)	3,35,000
Consolidated profit or loss for the year	7,07,000

5. No Non-controlling Interest as 100% shares of XYZ Ltd. are held by DEF Ltd.

6. Gain on Bargain Purchase ₹

Amount paid for 20,000 shares		34,00,000
Par value of shares	20,00,000	
DEF Ltd.'s share in acquisition date profits of XYZ Ltd.	32,85,000	(52,85,000)
Gain on Bargain Purchase		18,85,000

7. Value of Plant & Machinery ₹

DEF Ltd.		24,00,000
XYZ Ltd.	13,50,000	
Add: Appreciation on 1.10. 20X1	5,75,000	
	19,25,000	
Add: Depreciation for 2nd half charged on pre-revalued value	75,000	
Less: Depreciation on ₹ 20,00,000 for 6 months	(1,00,000)	19,00,000
		43,00,000

8. Consolidated retained earnings ₹

	DEF Ltd.	XYZ Ltd.	Total
As given	5,72,000	8,20,000	13,92,000
Consolidation Adjustments:			
(i) Elimination of pre-acquisition element [3,00,000 + 3,60,000]	0	(6,60,000)	(6,60,000)

(ii) Elimination of intra-group dividend	(2,00,000)	2,00,000	0
(iii) Impact of fair value adjustments	0	(25,000)	(25,000)
Adjusted retained earnings consolidated	3,72,000	3,35,000	7,07,000

Assumptions:

1. Investment in XYZ Ltd is carried at cost in the separate financial statements of DEF Ltd.
2. Appreciation of ₹10 lakhs in land & buildings is entirely attributable to land element only.
3. Depreciation on plant and machinery is on WDV method.
4. Acquisition-date fair value adjustment to inventories of XYZ Ltd. existing at the balance sheet date does not result in need for any write-down.

2 Consolidated Balance Sheet of Ram Ltd. and its subsidiary, Krishan Ltd. as on 31st March, 20X2

Particulars	Note No.	₹
I. Assets		
(1) Non-current assets		
(i) Property, Plant & Equipment	1	17,20,000
(ii) Goodwill	2	1,65,800
(2) Current Assets		
(i) Inventories	3	3,42,800
(ii) Financial Assets		
(a) Trade Receivables	4	1,99,600
(b) Cash & Cash equivalents	5	45,000
Total Assets		**24,73,200**
II. Equity and Liabilities		
(1) Equity		
(i) Equity Share Capital	6	10,00,000
(ii) Other Equity	7	7,30,600
(2) Non-controlling Interest (WN 5)		4,33,600
(3) Current Liabilities		
(i) Financial Liabilities		
(a) Trade Payables	8	1,49,000
(b) Short term borrowings	9	1,60,000
Total Equity & Liabilities		**24,73,200**

Notes to accounts

			₹
1.	**Property Plant & Equipment**		
	Land & Building	8,60,000	
	Plant & Machinery	8,60,000	17,20,000
2.	Goodwill		1,65,800
3.	**Inventories**		
	Ram Ltd.	2,40,000	
	Krishan Ltd.	1,02,800	3,42,800
4.	**Trade Receivables**		
	Ram Ltd.	1,19,600	
	Krishan Ltd.	80,000	1,99,600
5.	**Cash & Cash equivalents**		
	Ram Ltd.	29,000	
	Krishan Ltd.	16,000	45,000
8.	**Trade Payables**		
	Ram Ltd.	94,200	
	Krishan Ltd.	54,800	1,49,000
9.	**Short-term borrowings**		
	Bank overdraft		1,60,000

Statement of Changes in Equity:

6. Equity share Capital

Balance at the beginning of the reporting period	Changes in Equity share capital during the year	Balance at the end of the reporting period
10,00,000	0	10,00,000

7. Other Equity

	Share application money	Equity component	Reserves & Surplus			Total
			Capital reserve	Retained Earnings	Other Reserves	
Balance at the beginning of the reporting period				0	6,00,000	6,00,000

Total comprehensive income for the year			0	1,14,400		1,14,400
Dividends			0	(24,000)		(24,000)
Total comprehensive income attributable to parent			0	40,200		40,200
Gain on Bargain purchase				0		0
Balance at the end of reporting period				1,30,600	6,00,000	7,30,600

Working Notes:

1. **Adjustments of Fair Value**

   The Plant & Machinery of Krishan Ltd. would stand in the books at ₹ 2,85,000 on 1st October, 20X1, considering only six months' depreciation on ₹ 3,00,000 total depreciation being ₹ 30,000. The value put on the assets being ₹ 4,00,000 there is an appreciation to the extent of ₹ 1,15,000.

2. **Acquisition date profits of Krishan Ltd.**

Reserves on 1.4. 20X1		2,00,000
Profit & Loss Account Balance on 1.4. 20X1		60,000
Profit for 20X1-20X2: Total (₹ 1,64,000 less ₹ 20,000) x 6/12 i.e. ₹ 72,000; upto 1.10. 20X1		72,000
Total Appreciation		3,25,000
Total		6,57,000
Holding Co. Share (60%)		3,94,200

3. **Post-acquisition profits of Krishan Ltd.**

Profit after 1.10. 20X1 [1,64,000-20,000]x 6/12	72,000
Less: 10% depreciation on ₹ 4,00,000 for 6 months less depreciation already charged for 2nd half of 20X1-20X2 on ₹ 3,00,000 (20,000-15,000)	(5,000)
Total	67,000
Share of holding Co. (60%)	40,200

4. **Non-controlling Interest**

Par value of 1600 shares	160,000
Add: 2/5 Acquisition date profits (6,57,000 – 40,000)	2,46,800
2/5 Post-acquisition profits [WN 4]	26,800
	4,33,600

5. **Goodwill:**

Amount paid for 2,400 shares		8,00,000
Par value of shares	2,40,000	
Acquisition date profits share of Ram Ltd.	3,94,200	(6,34,200)
Goodwill		1,65,800

6. **Value of Plant & Machinery:**

Ram Ltd.		4,80,000
Krishan Ltd.	2,70,000	
Add: appreciation on 1.10. 20X1	1,15,000	
	3,85,000	
Add: Depreciation for 2nd half charged on pre-revalued value	15,000	
Less: Depreciation on ₹ 4,00,000 for 6 months	(20,000)	3,80,000
		8,60,000

7. **Profit & Loss account consolidated**

Ram Ltd. (as given)	1,14,400	
Less: Dividend	(24,000)	90,400
Share of Ram Ltd. in post-acquisition profits		40,200
		1,30,600

3. Blue Heavens Ltd. consolidated statement of financial position at 31 March 20X2 will be calculated as follows: (in lakhs)

	Blue Heavens Ltd.	**Orange County Ltd.**	**Consolidation adjustments**	**Consolidated Blue Heavens Ltd.**
	Carrying amount	**Carrying amount**		
Assets **Non-current assets** Goodwill			1,300 (WN 1)	1,300

Buildings and other PPE	7,000	3,000	300	10,300
Financial Assets				
Investment in Orange County Ltd.	6,000		(6,000)	
Current assets				
Inventories	700	500	100	1,300
Financial Assets				
Trade receivables	300	250		550
Cash	1,500	700		2,200
Total assets	**15,500**	**4,450**		**15,650**
Equity and liabilities				
Equity				
Share capital	5,000	2,000	(2,000)	5,000
Other Equity	10,200	2,300	(2,300)	10,200
Trade payable	300	150		450
Total liabilities and equity	**15,500**	**4,450**		**15,650**

Consolidation involves:

- Adding the statement of financial position of the parent and its subsidiary together line by line.
- Eliminating the carrying amount of the parent's investment in the subsidiary (because it is replaced by the goodwill and the fair value of the assets, liabilities and contingent liabilities acquired) and the pre-acquisition equity of the subsidiary (because that equity was not earned or contributed by the group but is part of what was purchased) and recognising the fair value adjustments together with the goodwill asset that arose on acquisition of the subsidiary.

1. Working for goodwill:

	(₹ in lakhs)
Consideration paid	6,000
Less: Acquisition date fair value of Orange County Ltd. net assets	(4,700)
Goodwill	1,300

2. Working for the acquisition date fair value of Orange County Ltd. net assets:

Acquisition date fair value of acquiree (Orange County Ltd.) assets	
Buildings and other PPE	3,300
Inventories	600
Trade receivables	250
Cash	700
Less: fair value of trade payables	(150)
Fair value of net assets acquired	4,700

4. Non-controlling interest

= 25 % × Orange County Ltd. identifiable net assets at fair value of ₹ 4,700

= ₹ 1,175.

Blue Heavens Ltd. consolidated statement of financial position at 31 March 20X2 will be calculated as follows:

(in lakhs)

	Blue Heavens Ltd.	**Orange County Ltd.**	**Consolidation adjustments**	**Consolidated Blue Heavens Ltd.**
	Carrying amount	**Carrying amount**		
Assets				
Non-current assets				
Goodwill			975 (WN 1)	975
Buildings and other PPE	7,000	3,000	300	10,300
Financial Assets				
Investment in Orange County Ltd.	4,500		(4,500)	
Current assets				
Inventories	700	500	100	1,300
Financial Assets				

Trade receivables	300	250		550
Cash	3,000	700		3,700
Total assets	**15,500**	**4,450**		**16,825**
Equity and liabilities				
Equity				
Share capital	5,000	2,000	(2,000)	5,000
Other Equity	10,200	2,300	(2,300)	10,200
Non-controlling interest			1,175	1,175
Current liabilities				
Financial Liabilities				
Trade payables	300	150		450
Total liabilities and equity	**15,500**	**4,450**		**16,825**

Note: In this question, Blue Heavens Ltd.'s (and consequently the group's) cash balance is ₹ 1,500 lakh higher than in Question above because, in this example, Blue Heavens Ltd. paid ₹ 1,500 less to acquire Orange County Ltd. (ie ₹ 6,000 less ₹ 4,500).

1. **Working for goodwill:**

	(₹ in lakhs)
Consideration paid	4,500
Non- controlling interest	1,175
Less: Acquisition date fair value of Orange County Ltd. net assets (cal. as above)	4,700
Goodwill	975

(Goodwill recognised in the consolidated statement of financial position relates solely to the acquirer's proportion of the subsidiary; it does not include the non-controlling interest's share).

5. Alternative I for calculation of Non-controlling Interest:

The Non-controlling Interest proportion of Orange County Ltd. is 25 %.

At 31 March 20X3, the NCI in the consolidated statement of financial position would be calculated as:

	₹ (lakh)
NCI at date of acquisition (31 March 20X2) (see solution to Question 4)	1,175
NCI's share of profit for the year ended 31 March 20X3, being 25% Of ₹ 435 lakh (being ₹ 550 profit of Orange County Ltd. as per Orange County Ltd. financial statements less ₹ 100 group inventory Fair value adjustment less ₹ 15 group depreciation on building fair value adjustment)*	109
NCI as at 31 March 20X3	1,284

*In calculating the NCI's share of profit for the year ended 31 March 20X3, no deduction is made for goodwill amortisation because, as explained above, the goodwill arising on consolidation relates solely to the acquirer's proportion of the subsidiary and does not include the non-controlling interest's share.

Alternative II for calculation of Non-controlling Interest:

As an alternative to the above three-step approach, at 31 March 20X3 the NCI in the consolidated statement of financial position is calculated as 25% (the NCI's proportion) of ₹ 5,135, which is ₹ 1,284. ₹ 5,135 is Orange County Ltd. net assets at 31 March 20X3 as shown in Orange County Ltd. statement of financial position (₹ 4,850, being ₹ 5,020 assets less ₹ 170 liabilities) plus the fair value adjustment to those assets as made in preparing the group statement of financial position (₹ 285, being the fair value adjustment in respect of Orange County Ltd. building, ₹ 300, less one year's depreciation of that adjustment, ₹ 15).

Blue Heavens Ltd. consolidated statement of comprehensive income for the year ended 31 March 20X3 will be computed as follows:

	Blue Heavens Ltd.	Orange County Ltd.	Consolidate adjustments	Consolidated
Revenue	3,000	1,900		4,900
Cost of sales	(1,800)	(1,000)	(100) (WN 1)	(2,900)
Profit for the year	1,200	900		2,000
Administrative expenses	(400)	(350)	(113) (WN 2)	(863)

Total comprehensive income for the year	800	550		1,137

Total comprehensive income attributable to:

Owners of the parent (75%)	1,028
Non-controlling interest (25%)	109
	1,137

Consolidation involves:

- Adding the statement of comprehensive income of the parent and its subsidiary together line by line
- Recognising the fair value adjustments and/ or amortisation thereof together with amortisation of the goodwill asset that arose on acquisition of the subsidiary.

Blue Heavens Ltd. consolidated statement of financial position at 31 March 20X3 will be computed as follows: (₹ in lakh)

	Blue Heavens Ltd.	**Orange County Ltd.**	**Consolidation adjustments**	**Consolidated Blue Heavens Ltd.**
	Carrying amount	**Carrying amount**		
Assets				
Non-current assets				
Goodwill			975-98 (WN 3)	877
Buildings and other PPE	6,500	2,750	285 (WN 4)	9,535
Financial Assets				
Investment in Entity B	4,500		(4,500)	
Current assets				
Inventories	800	550		1,350
Financial Assets				
Trade receivables	380	300		680
Cash	4,170	1420		5,590
Total assets	16,350	5,020		18,032
Equity and liabilities				
Equity				

Share capital	5,000	2,000	(2,000)	5,000
Other Equity	11,000	2,850	(2,622) (WN 5)	11,228
Non-controlling interest			1,284	1,284
Current liabilities				
Financial Liabilities				
Trade payables	350	170		520
Total liabilities and equity	16,350	5,020		18,032

Consolidation involves:

- Adding the statement of financial position of the parent and its subsidiary together line by line.
- Eliminating the carrying amount of the parent's investment in the subsidiary (because it is replaced by the goodwill and the fair value of the assets, liabilities and contingent liabilities acquired) and the pre-acquisition equity of the subsidiary (because that equity was not earned or contributed by the group but is part of what was purchased), and recognising the fair value adjustments together with the goodwill asset that arose on acquisition of the subsidiary as adjusted to reflect the first year post-acquisition
- Recognising the non-controlling interest in the net assets of Entity B.

Working Notes:

(1) Cost of sales adjustment:

₹ 100 = fair value adjustment in respect of inventories at 31 March 20X2.

(2) Administrative expenses adjustment:

₹ 113 = Amortisation of goodwill ₹ 98 (WN 3) + additional depreciation on building ₹ 15 (WN 4).

For simplicity it is assumed that all the goodwill amortisation and the additional buildings depreciation is adjusted against administrative expenses.

(3) Working for goodwill:

Goodwill at the acquisition date, ₹ 975, less accumulated amortisation, which this year is amortisation for one year, ₹ 98 approx. (ie ₹ 975 ÷ 10 years) = ₹ 877.

(4) Working for building consolidation adjustment:

The fair value adjustment at 31 March 20X2 in respect of Orange County Ltd. building was ₹ 300, that is, the carrying amount at 31 March 20X2 was ₹ 300 lower than was recognised in the group's consolidated statement of financial position. The building is being depreciated over 20 years from 31 March 20X2. Thus at 31 March 20X3 the adjustment required on consolidation to the statement of financial position will be ₹ 285, being ₹ 300 × 19/20 years' estimated useful life remaining. The additional depreciation recognised in the consolidated statement of comprehensive income is ₹ 15 (being ₹ 300 x 1/20).

(5) Reserves adjustment:

₹ 2,300 adjustment at the acquisition date (Illustration 4) plus ₹ 98 (WN 3) amortisation of goodwill plus ₹ 15 (WN 4) additional depreciation on building plus ₹ 100 (WN 1) fair value adjustment in respect of inventories plus ₹ 109 NCI's share of Orange County Ltd. profit for the year (as included in the consolidated statement of comprehensive income) = ₹ 2,622.

6. **When 100% shares sold to independent party**

Consolidated Balance Sheet of P Pvt. Ltd. and its remaining subsidiaries as on 31st March, 20X2

Particulars	**Note No.**	**(₹ in millions)**
I. Assets		
(1) Non-current assets		
(i) Property Plant & Equipment	1	1,900
(ii) Goodwill	2	200
(2) Current Assets		
(i) Inventories	3	100
(ii) Financial Assets		
(a) Trade Receivables	4	800
(b) Cash & Cash equivalents	5	5,100
Total Assets		**8,100**
II. Equity and Liabilities		
(1) Equity		
(i) Equity Share Capital	6	1,600
(ii) Other Equity	7	4,700
(2) Non-controlling Interest		
(3) Current Liabilities		
(i) Financial Liabilities		
(a) Trade Payables	8	1,800
Total Equity & Liabilities		**8,100**

Notes to accounts:

			(₹ in millions)
1.	**Property Plant & Equipment**		
	Land & Building	3,240	
	Less: S Pvt. Ltd.	(1,340)	1,900
2.	**Goodwill**	380	
	Less: S Pvt. Ltd.	(180)	200
3.	**Inventories**		
	Group	140	
	Less: S Pvt. Ltd.	(40)	100
4.	**Trade Receivables**		
	Group	1,700	
	Less: S Pvt. Ltd.	(900)	800
5.	**Cash & Cash equivalents**		
	Group (WN 2)	5,100	5,100
8.	**Trade Payables**		
	Group	2,700	
	Less: S Pvt. Ltd.	900	1,800

Statement of changes in Equity:

6. Equity share Capital

Balance at the beginning of the reporting period	Changes in Equity share capital during the year	Balance at the end of the reporting period
1600	0	1600

7. Other Equity

	Share application money	Equity component	Reserves & Surplus			Total
			Capital reserve	Retained Earnings	Securities Premium	
Balance at the beginning				4,260		4,260

Total comprehensive income for the year			0			
Dividends			0			
Total comprehensive income attributable to parent			0			
Gain on disposal of S Pvt. Ltd.				440		440
Balance at the end of reporting period			0	4,700		4,700

Working Notes:

1. When sold, the carrying amount of all assets and liabilities attributable to S Pvt. Ltd. were eliminated from the consolidated statement of financial position.
2. Cash on hand (in millions):

Cash before disposal of S Pvt. Ltd.	3,100
Less: S Pvt. Ltd. Cash	(1,000)
Add: Cash realized from disposal	3,000
Cash on Hand	5,100

3. Gain/ Loss on disposal of entity (in millions):

Proceeds from disposal	3,000
Less: Net assets of S Pvt. Ltd.	(2,560)
Gain on disposal	440

4. Retained Earnings (in millions):

Retained Earnings before disposal	4,260
Add: Gain on disposal	440
Retained earnings after disposal	4,700

7. **When 90% shares sold to independent party**

Consolidated Balance Sheet of Reliance Ltd. and its remaining subsidiaries as on 31st March, 20X2

Particulars	Note No.	(₹ In '000)
I. Assets		
(1) Non-current assets		
(i) Property Plant & Equipment	1	950
(ii) Goodwill	2	100
(iii) Financial Assets		
(a) Investments	3	128
(2) Current Assets		
(i) Inventories	4	50
(ii) Financial Assets		
(b) Trade Receivables	5	400
(c) Cash & Cash equivalents	6	2,050
Total Assets		3,678
II. Equity and Liabilities		
(1) Equity		
(i) Equity Share Capital	7	800
(ii) Other Equity	8	1,978
(2) Current Liabilities		
(i) Financial Liabilities		
(a) Trade Payables	9	900
Total Equity & Liabilities		3,678

Notes to accounts:

			(₹ In '000)
1.	**Property Plant & Equipment**		
	Land & Building	1620	
	Less: Reliance Jio Infocomm Ltd.	(670)	950

2.	**Goodwill**	190	
	Less: Reliance Jio Infocomm Ltd.	(90)	100
3.	**Investments**		
	Investment in Reliance Jio Infocomm Ltd. (WN 2)	128	128
4.	**Inventories**		
	Group	70	
	Less: Reliance Jio Infocomm Ltd.	(20)	50
5.	**Trade Receivables**		
	Group	850	
	Less: Reliance Jio Infocomm Ltd.	(450)	400
8.	**Cash & Cash equivalents**		
	Group (WN 3)	2,050	2,050
	Trade Payables		
	Group	1,350	
	Less: Reliance Jio Infocomm Ltd.	450	900

Statement of changes in Equity:

6. Equity share Capital

Balance at the beginning of the reporting period	Changes in Equity share capital during the year	Balance at the end of the reporting period
800	0	800

7. Other Equity

	Share application money	Equity component	Reserves & Surplus			Total
			Capital reserve	Retained Earnings	Securities Premium	
Balance at the beginning				2,130		2,130
Total comprehensive income for the year			0			
Dividends			0			
Total comprehensive			0			

income attributable to parent						
Loss on disposal of Reliance Jio Infocomm Ltd.				(152)		(152)
Balance at the end of reporting period			0	1,978		1,978

Working Notes:

1. When 90% being sold, the carrying amount of all assets and liabilities attributable to Reliance Jio Infocomm Ltd. were eliminated from the consolidated statement of financial position and further financial asset is recognized for remaining 10%.

2. Fair value of remaining investment (in '000):

Net Assets of Reliance Ltd.	1,280
Less: 90% disposal	(1152)
Financial Asset	128

3. Cash on hand (in '000):

Cash before disposal of Reliance Jio Infocomm Ltd.	1,550
Less: Reliance Jio Infocomm Ltd. Cash	(500)
Add: Cash realized from disposal	1,000
Cash on Hand	2,050

4. Gain/ Loss on disposal of entity (in '000):

Proceeds from disposal	1,000
Less: Proportionate (90%) Net assets of Reliance Jio Infocomm Ltd. (90% of 1,280)	(1,152)
Loss on disposal	(152)

5. Retained Earnings (in '000):

Retained Earnings before disposal	2,130
Less: Loss on disposal	(152)
Retained earnings after disposal	1,978

8. Journal Entries in Airtel Infrastructures Pvt. Ltd.

1.	Assets(Land) A/c	Dr.	10,25,000	
	To cash			10,25,000
2.	Depreciation (P/L) A/c	Dr.	25,000	
	To Asset (Land)			25,000
3.	Cash A/c	Dr.	11,00,000	
	To Asset (Land)			10,00,000
	To P/L			1,00,000

Journal Entries in Airtel Telecommunications Ltd.

1.	Asset (Land) A/c	Dr.	11,00,000	
	To Cash			11,00,000
2.	Depreciation (P/L) A/c	Dr.	37,500	
	To Assets (Land)			37,500

Journal entry for consolidation:

1.	Asset (Land) A/c	Dr.	5,000 (WN 1)	
	To Consolidated P&L			5,000

Working Note:

To be depreciated on original value	(10,00,000-3,50,000)/20	32,500
Depreciation charged	(11,00,000-3,50,000)/20	37,500
Reversal of depreciation		**5,000**

Particulars	**Consolidated financial statements**	**Individual Financial statements**	
		Airtel Telecommunications Ltd.	**Airtel Infrastructures Pvt. Ltd.**
31st March 20X1	10,00,000	0	10,00,000
1st April 20X1 purchase sale	0	11,00,000	(10,00,000)
Depreciation	(32,500)	(37,500)	0
31st March 20X2	9,67,500	10,62,500	0

9. Paragraph 25 of Ind AS 110 states that if a parent loses control of a subsidiary, the parent:

(a) derecognises the assets and liabilities of the former subsidiary from the consolidated balance sheet.

(b) recognises any investment retained in the former subsidiary at its fair value when control is lost and subsequently accounts for it and for any amounts owed by or to the former subsidiary in accordance with relevant Ind ASs. That fair value shall be regarded as the fair value on initial recognition of a financial asset in accordance with Ind AS 109 or, when appropriate, the cost on initial recognition of an investment in an associate or joint venture.

(c) recognises the gain or loss associated with the loss of control attributable to the former controlling interest."

Paragraph B98(c) of Ind AS 110 states that on loss of control over a subsidiary, a parent shall reclassify to profit or loss, or transfer directly to retained earnings if required by other Ind AS, the amounts recognised in other comprehensive income in relation to the subsidiary on the basis specified in paragraph B99.

As per paragraph B99, if a parent loses control of a subsidiary, the parent shall account for all amounts previously recognised in other comprehensive income in relation to that subsidiary on the same basis as would be required if the parent had directly disposed of the related assets or liabilities.

Therefore, if a gain or loss previously recognised in other comprehensive income would be reclassified to profit or loss on the disposal of the related assets or liabilities, the parent shall reclassify the gain or loss from equity to profit or loss (as a reclassification adjustment) when it loses control of the subsidiary. If a revaluation surplus previously recognised in other comprehensive income would be transferred directly to retained earnings on the disposal of the asset, the parent shall transfer the revaluation surplus directly to retained earnings when it loses control of the subsidiary.

In view of the basis in its consolidated financial statements, AB Limited shall:

(a) re-classify the FVOCI reserve in respect of the debt investments of ₹ 5.4 crore (90% of ₹ 6 crore) attributable to the owners of the parent to the statement of profit or loss in accordance with paragraph B5.7.1A of Ind AS 109, Financial Instruments which requires that the cumulative gains or losses previously recognised in OCI shall be recycled to profit and loss upon derecognition of the related financial asset. This is reflected in the gain on disposal. Remaining 10% (i.e., ₹ 0.6 crore) relating to non-controlling interest (NCI) is included as part of the carrying amount of the non-controlling interest that is derecognised in calculating the gain or loss on loss of control of the subsidiary;

(b) transfer the reserve relating to the net measurement losses on the defined benefit liability of ₹ 2.7 crore (90% of ₹ 3 crore) attributable to the owners of the parent within equity to retained earnings. It is not reclassified to profit or loss. The remaining 10% (i.e., ₹ 0.3 crore) attributable to the NCI is included as part of the carrying amount of NCI that is derecognised in calculating the gain or loss on loss of control over the subsidiary. No amount is reclassified to profit or loss, nor is it transferred within equity, in respect of the 10% attributable to the non-controlling interest.

(c) reclassify the cumulative gain on fair valuation of equity investment of ₹ 3.6 crore (90% of ₹ 4 crore) attributable to the owners of the same parent from OCI to retained earnings under equity as per paragraph B5.7.1 of Ind AS 109, Financial Instruments, which provides that in case an entity has made an irrevocable election to recognise the changes in the fair value of an investment in an equity instrument not held for trading in OCI, it may subsequently transfer the cumulative amount of gains or loss within equity. Remaining 10% (i.e., ₹ 0.4 crore) related to the NCI are derecognised along with the balance of NCI and not reclassified to profit and loss.

(d) reclassify the foreign currency translation reserve of ₹ 7.2 crore (90% × ₹ 8 crore) attributable to the owners of the parent to statement of profit or loss as per paragraph 48 of Ind AS 21, The Effects of Changes in Foreign Exchange Rates, which specifies that the cumulative amount of exchange differences relating to the foreign operation, recognised in OCI, shall be reclassified from equity to profit or loss on the disposal of foreign operation. This is reflected in the gain on disposal. Remaining 10% (i.e., ₹ 0.8 crore) relating to the NCI is included as part of the carrying amount of the NCI that is derecognised in calculating the gain or loss on the loss of control of subsidiary, but is not reclassified to profit or loss in pursuance of paragraph 48B of Ind AS 21, which provides that the cumulative exchange differences relating to that foreign operation attributed to NCI shall be derecognised on disposal of the foreign operation, but shall not be reclassified to profit or loss.

The impact of loss of control over BC Limited on the consolidated financial statements of AB Limited is summarised below:

(Rupees in crore)

Particular	Amount (Dr)	Amount (Cr)	PL Impact	RE Impact
Gain / Loss on Disposal on Investments				
Bank	56			
Non-controlling interest (Derecognised)	6			
Investment at FV (20% Retained)	16			
Gain on Disposal (PL) balancing figure		18	18	
De-recognition of total net assets of subsidiary	60			
Reclassification of FVTOCI reserve on debt instruments to profit or loss				
FVTOCI reserve on debt instruments (6 cr. x 90%)	5.4			
To Profit and loss	5.4	5.4		

Reclassification of net measurement loss reserve to profit or loss				
Reserve and Surplus	2.7			-2.7
To Net measurement loss reserve (FVTOCI) [(3 cr. x 90%)]		2.7		
Reclassification of FVTOCI reserve on equity instruments to retained earnings				
FVTOCI reserve on equity instruments (4 cr.x 90%)	3.6			
To Reserve and Surplus		3.6		3.6
Foreign currency translation reserve reclassified to profit or loss				
Foreign currency translation reserve (FVOCI) [8 cr. x 90%]	7.2			
To Profit and loss		7.2	7.2	
Total			30.6	0.9

CHAPTER 15

ANALYSIS OF FINANCIAL STATEMENTS

LEARNING OUTCOMES

After studying this chapter, you would be able to:

- Examine the key features of the financial statements and its relevancy for better reporting.
- Examine the key factors to be kept in mind in the preparation of financial statements.
- Follow the best practices in the preparation of financial statements.
- Analyse the common mistakes incurred by the preparers of the financial statements in the presentation of financial statements with respect to Schedule III.
- Rectify the mistakes found in the financial statements by addressing the issues and prescribing the correct presentation and disclosures.

CHAPTER OVERVIEW

Analysis of Financial Statements

- Characteristics of good financial statements
  - True and fair view
  - Relevance
  - Understand ability
  - Consistency
  - Regulatory Compliance
  - Universality
- Best Practices
  - Compliance
  - Complete
  - Simple and specific
  - Transparency
  - Materiality
  - Integration of Notes
  - Disclosure of significant accounting
  - Disclosures of key estimates and judgements
  - Integrated approach
- Common Defects in FS
  - Schedule III Disclosure
  - Disclosure of Balance Sheet Items
  - Disclosure of Statement of Profit and Loss Items
  - Disclosure of Other Items of Financial Statements
  - Other Constituents of Financial Statements
  - Consolidated Financial Statements
- Illustrations
  - Based on Ind AS

1. INTRODUCTION

Business is important organ of society that helps in its overall development. A typical business has a variety of stakeholder that include its employees, owners, banks, trade associations, government, general public and so on. These stakeholders, particularly investors are keenly interested in knowing about the financial well-being of business organisations.

Financial reporting is an important means of communication for entities to disseminate information of its operations to various stakeholders. With the increased focus on governance the significance of financial reporting has exponentially increased. The importance of robust financial reporting cannot be emphasized enough. As India and Indian enterprises move ahead in the growth path at much faster pace and exposure of Indian entities to global environment expands, ever increasing complexities of transactions throws up newer challenges in financial reporting and related guidance. Presentation and disclosures, in this context, are assuming greater significance as enterprises aim to achieve excellence in financial reporting. Today, there are a number of requirements mandated by the regulators. It has now become imperative for entities to keep pace with the fast evolving requirements in the area of financial reporting.

The financial statements are a source of critical communication between an entity and the investors and other stakeholders. They act as the barometer to assess the performance, both past and future, for any enterprise. Decades back when enterprises were mostly proprietary owned, the financial statements were simpler in content and were presented annually just to provide the historical data. However, with globalization and increased dependence on technology, where companies are expanding both horizontally and vertically, many even spanning across geographies; the number of stakeholders – be it be investors, suppliers, employees, or even tax authorities, have increased manifold.

The financial statements are supplemented with the disclosures which are the key source of information and help the users in interpreting the financial statements in a better manner in taking appropriate decisions. Therefore, one can say that disclosures are added for good reasons. Disclosures are not the only requirement which will make a financial statement to be a good financial statement. The presentation and the compliance of formats are also the important factors which are taken into consideration in the evaluation of a financial statement.

This chapter enumerates some of the practices currently being followed in financial reporting and sets out suggested 'best practice' to enhance the quality of financial reporting to enable preparers of financial statements in benchmarking their financial statements. It intends to bring to the notice of the preparers and reviewers of the financial statements some common errors or omissions which they shall avoid while preparing the financial statements.

2. FINANCIAL STATEMENTS OF CORPORATE ENTITIES

The format and content of the financial statements for companies is required to be in accordance with Schedule III to the Companies Act, 2013. Further, there are several additional disclosure requirements both with respect to the balance sheet and statement of profit and loss.

Certain industries have formats specified by their industry regulators, which need to be followed by them. This fact has also been recognised in the Companies Act, 2013 in the proviso to Section 129(1) which implies that the format set out in Schedule III will not be applicable to insurance companies and banking companies. The formats for these companies are prescribed by specific regulators.

In terms of format, Schedule III only prescribes the vertical format of balance sheet and does not provide the alternative of using the horizontal format. Further, Schedule III sets out the minimum requirements for disclosure on the face of the balance sheet and the statement of profit and loss. It allows line items, sub-line items and sub-totals to be presented as an addition or substitution on the face of the financial statements when such presentation is relevant to an understanding of the company's financial position or performance or to cater to industry/sector-specific disclosure requirements or when required for compliance with the amendments to the Companies Act or under the Standards. Schedule III now requires all disclosures to be made as a part of the notes.

Apart from granting an overriding status to the Standards, cognizance has also been given to the requirements of Standards in the format of the balance sheet and accordingly elements such as deferred tax assets and intangible assets have been included in the balance sheet. Also, it has been clearly stated that the disclosure requirements specified in Part I and Part II or Part III of the Schedule III are in addition to and not in substitution of the disclosure requirements specified in the respective notified Standards. The terms used in Schedule III are to be considered as per the respective notified Standards.

One of the pertinent aspect which needs to be considered in the preparation of financial statements with regard to Schedule III is that it does not prescribe the accounting treatment to be adopted by the entity; it only prescribes the format and content. Consequently, the fact that a particular item has been included in the format of the balance sheet in Schedule III does not imply that the particular item can be recognized in the balance sheet. Schedule III prescribes only presentation and not treatment which is a subject matter of Standards, which has also been specifically acknowledged in Schedule III.

3. CHARACTERISTICS OF GOOD FINANCIAL STATEMENTS

In the Indian scenario, the ICAI has been the recognized accounting body issuing generally accepted accounting policies, and has made the standards mandatory for enterprises operating within India. Besides Accounting Standards, ICAI has also issued the converged set of Ind AS that is adopted and notified by MCA, and many large entities have already implemented it or are in the transition phase for adoption (depending on the net worth or other specified criteria).

The key features to any set of financial statements are:

1. **True and fair view of the affairs of the enterprise:** This is the most important feature of any set of financial statements. The user of the financial statements depends fully on the same and hence the reliability factor is supreme.

2. **Relevance:** The financial statements should provide the relevant information for the period it is presented. There is no point in presenting historical data of past several years that are redundant as of date. The key here is that the user of the financial statements should be in a position to take independent decision after reading the financial statements. This decision can be different for different users – for an investor the decision whether to hold the shares of the enterprise will stem from the set of statements, for a senior employee of the company it can be the future growth prospects of the company etc. But what is important is that the users should be empowered to make decisions through the financial statements

3. **Understandability:** For the user to make sense, the financial statements should be readable and content lucid to digest. Even a layman should be able to read the same, and understand the basic information, if not the accounting policies and procedures.

4. **Consistency:** The users of the financial statements will be benefitted only if the statements are released in periodic intervals and in standard formats. Else, the entire purpose of furnishing financials will be defeated. That's the reason that laws are prescribed for presentation formats and periodicity.

5. **Regulatory Compliance:** Needless to say, the tax authorities, market regulators etc. rely hugely on financial statements to understand and gauge the compliances met by the enterprise.

6. **Universality:** Last but not the least; the financial statements should be comparable both within the industry and outside. So financial statements by two different companies should look in similar lines if both are engaged in, say, manufacturing steel. Likewise, the financials of a company manufacturing steel in India should be comparable to the set of financial statements of a company based out of US engaged in the similar line of business.

The need to have the above key characteristics have brought the accounting bodies world over to come together to have a set of common standards for better integration and harmonization of accounting principles and practices.

4. BEST PRACTICES - APPLICABLE TO ALL COMPANIES

Following are some of the practices, if followed by the preparers of the financial statements, it would lead to better presentation and disclosure and will also serve the meaningful purpose for various stakeholders in understanding the functioning, financial position and financial performance of the entity and in appropriate decision making:

1. Compliance

Financial reporting is a regulated activity and compliance with the requirements is a must. Comply with the standards and regulations but also ensure your financial statements are an effective part of your wider communication with your stakeholders. It should be simple and understandable without any change in the interpretation.

Example :

Usage of the term 'remaining maturity' instead of 'original maturity' while describing cash and cash equivalents.

2. Complete

The information disclosed in the financial statements should be complete and should not lead to any further cross questioning in the mind of the users. Ensure consistency of disclosures across the financial statements.

Example :

Where the accounting policy states that "Balances of debtors, creditors and loans and advances are subject to reconciliations and confirmations". This indicates that these balances may or may not be appropriately stated as well as raising questions regarding the appropriateness of the audit process.

3. Simple and specific

- Draft your notes, accounting policies, commentary on more complex areas in simple and plain English. Ensuring that there are no vague or ambiguous notes.

Example :

The definition of a derivative and a hedged item and how the company uses such items:

"A derivative is a type of financial instrument the company uses to manage risk. It is something that derives its value based on an underlying asset. It's generally in the form of a contract between two parties entered into for a fixed period. Underlying variables, such as exchange rates, will cause its value to change over time. A hedge is where the company uses a derivative to manage its underlying exposure. The company's main exposure is to fluctuation in foreign exchange risk. We manage this risk by hedging forex movements, in effecting the boundaries of exchange rate changes to manageable, affordable amounts."

- Make your policies clear and specific.
- Ensure that there should not be any vague or ambiguous notes, with no further information or explanation which may lead to misinterpretation of information.
- Reduce generic disclosures and focus on company specific disclosures that explain how the company applies the policies.

Example :

A note stated "Land not registered in the name of the company has been given for the use of group companies". However, there are no disclosures regarding such lease elsewhere in the financial statements. This leads to ambiguity regarding whether the land has been capitalized in the books of account or not.

A better disclosure would be to include this note in the note relating to 'Property, plant and Equipment' with an asterix against land and a note which states "Land includes area measuring XX acres, towards which the registration process is still in progress. This land has been given on lease to group companies."

4. Transparency

In preparation of financial statements many a times certain assumptions, or other bases are taken. Disclose those assumptions and bases transparently, so that they users are not misled. Rather such transparency shall provide useful additional information and substantiate your decision/judgement.

5. Materiality

- The lack of clarity in how to apply the concept of materiality is perceived to be one of the main drivers for overloaded financial statements. Make effective use of materiality to enhance the clarity and conciseness of your financial statements.
- Information should only be disclosed if it is material. It is material if it could influence users' decisions which are based on the financial statements.
- Your materiality assessment is the 'filter' in deciding what information to disclose and what to omit.
- Once you have determined which specific line items require disclosure, you should assess what to disclose about these items, including how much detail to provide and how best to organise the information.

Example: Capital Commitments

A company has committed to purchase several items of property, plant and equipment. Individually each purchase is immaterial. However, the total amounts to a material commitment for the company and therefore some disclosure should be made regarding this commitment.

Example : New Revenue Stream

A company in the software sector has communicated to its stakeholders a strategic intention to focus its new development efforts in cloud-based solutions. In a particular financial year cloud-based revenues are less than 5% of the total but have grown rapidly. The company therefore decides to provide separate disclosure about this revenue stream in accordance with Ind AS 108 'Operating Segments' even though other revenue streams of similar size are typically combined into 'other revenue.'

6. Integration of Notes

- Notes cover the largest portion of the financial statements. They are an effective tool of communication and have the greatest impact on the effectiveness of your financial statements.
- Group notes into categories, place the most critical information more prominently or a combination of both.

- Integrate your main note of a line item with its accounting policy and any relevant key estimates and judgements.

Example: Inventories

1. Accounting Policy

Inventories are stated at the lower of cost and net realisable value. Cost includes all expenses directly attributable to the manufacturing process as well as suitable portions of related production overheads, based on normal operating capacity. Costs of ordinarily interchangeable items are assigned using the first in, first out cost formula. Net realisable value is the estimated selling price in the ordinary course of business less any applicable selling expenses.

2. Significant Estimation of Uncertainty

Management estimates the net realisable values of inventories, taking into account the most reliable evidence available at each reporting date. The future realisation of these inventories may be affected by future technology or other market-driven changes that may reduce future selling prices.

3. Inventories consist of the following: (₹ in crores)

	31st March, 20X2	31st March, 20X1
Raw materials and consumables	7,000	6,000
Merchandise	11,000	9,000
	18,000	15,000

- Ensuring that the accounting policies are disclosed in one place and not scattered across various notes.

  For example, in one case it was observed that the policy of recognizing 100% depreciation on assets costing less than ₹ 5,000 was specified in the note on fixed assets, rather than in the accounting policy for fixed assets.

7. Disclosure of Significant Accounting Policies

- The financial statements should disclose your significant accounting policies. Disclose only your significant accounting policies – remove your non-significant disclosures that do not add any value.
- Your disclosures should be relevant, specific to your company and explain how you apply your policies.
- The aim of accounting policy disclosures is to help your investors and other stakeholders to properly understand your financial statements.

- Use judgement to determine whether your accounting policies are significant, considering not only the materiality of the balances or transactions affected by the policy but also other factors including the nature of the company's operations.

Example:

Taxable temporary differences arise on certain brands and licenses that were acquired in past business combinations. Management considers that these assets have an indefinite life and are expected to be consumed by use in the business. For these assets deferred tax is recognised using the capital gains tax applicable on sale.

8. Disclosures of Key Estimates and Judgements

- Effective disclosures about the most important estimates and judgements enable investors to understand your financial statements.
- Focus on the most difficult, subjective and complex estimates.
- Include details of how the estimate was derived, key assumptions involved, the process for reviewing and an analysis of its sensitiveness.
- Provide sufficient background information on the judgement, explain how the judgement was made and the conclusion reached.

9. Integrated Approach

- Financial statements are just one part of your communication with the stakeholders. An annual report typically includes financial statements, a management commentary and information about governance, strategy and business developments, CSR Reporting, Business Responsibility Reporting etc. There is also a growing trend towards integrated reporting.
- To ensure overall effective communication consider the annual report as a whole and deliver a consistent and coherent message throughout.
- Ind AS 1 also acknowledges that one may present, outside the financial statements, a financial review that describes and explains the main features of the company's financial performance and financial position, and the principal uncertainties it faces.
- Many companies also present, outside the financial statements, reports and statements such as environmental reports and value added statements, particularly in industries in which environmental factors are significant and when employees are regarded as an important user group.
- Even though the reports and statements presented outside financial statements are outside the scope of AS / Ind AS, they are not out of the scope of regulation.

Example :

CSR disclosures, as required by the Companies Act, 2013. in section 134 and Schedule VII.

5. CASE STUDIES BASED ON IND AS

Case Study 1

On 1st April, 20X1, Pluto Ltd. has advance a loan for ₹10 lakhs to one of its employees for an interest rate at 4% per annum (market rate 10%) which is repayable in 5 equal annual installments along with interest at each year end. Employee is not required to give any specific performance against this benefit.

The accountant of the company has recognised the staff loan in the balance sheet equivalent to the amount disbursed i.e. ₹10 lakhs. The interest income for the period is recognised at the contracted rate in the Statement of Profit and Loss by the company i.e. ₹40,000 (₹10 lakhs x 4%).

Analyse whether the above accounting treatment made by the accountant is in compliance with the Ind AS. If not, advise the correct treatment alongwith working for the same.

Solution

The above treatment needs to be examined in the light of the provisions given in Ind AS 32 and Ind AS 109 on *Financial Instruments*' and Ind AS 19 '*Employee Benefits'.*

Para 11 (c) (i) of Ind AS 32 *'Financial Instruments : Presentation'* states that:

"A financial asset is any asset that is:

(c) a contractual right:

(i) to receive cash or….."

Further, paragraph 5.1.1 of Ind AS 109 states that:

*"at initial recognition, an entity shall measure a financial asset or financial liability at its fair value"***.**

Further, paragraph 5.1.1 of Appendix B to Ind AS 109 states that:

"The fair value of a financial instrument at initial recognition is normally the transaction price (i.e. the fair value of the consideration given or received. However, if part of the consideration given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument. For example, the fair value of a long term loan or receivable that carries no interest can be measured as the present value of all future cash receipts discounted using the prevailing market(s) of interest rate of similar instrument with a similar credit rating. Any additional amount lent is an expense or reduction of income unless it qualifies for recognition as some other type of asset".

Further, paragraph 5.2.1 of Ind AS 109 states that:

"After initial recognition, an entity shall measure a financial asset at:

(a) amortised cost;

(b) *fair value through other comprehensive income; or*

(c) *fair value through profit or loss.*

Further, paragraph 5.4.1 of Ind AS 109 states that:

"Interest revenue shall be calculated by using the effective interest method. This shall be calculated by applying the effective interest rate to the gross carrying amount of a financial asset"

Paragraph 8 of Ind AS 19 states that:

"Employee Benefits are all forms of consideration given by an entity in exchange for service rendered by employees or for the termination of employment".

The Accountant of Pluto Ltd. has recognised the staff loan in the balance sheet at ₹ 10 lakhs being the amount disbursed and ₹ 40,000 as interest income for the period is recognised at the contracted rate in the statement of profit and loss which is not correct and not in accordance with Ind AS 19, Ind AS 32 and Ind AS 109.

Accordingly, the staff advance being a financial asset shall be initially measured at the fair value and subsequently at the amortised cost. The interest income is calculated by using the effective interest method. The difference between the amount lent and fair value is charged as Employee benefit expense in statement of profit and loss.

a) **Calculation of Fair Value of the Loan**

Year	Cash Inflow	Discounting Factor (10%)	Present Value
1	2,40,000	0.909	2,18,160
2	2,32,000	0.826	1,91,632
3	2,24,000	0.751	1,68,224
4	2,16,000	0.683	1,47,528
5	2,08,000	0.621	1,29,168
Total			**8,54,712**

Staff loan should be initially recorded at ₹ 8,54,712.

b) **Employee Benefit Expense**

Loan Amount – Fair Value of the loan = ₹ 10,00,000 – ₹ 8,54,712 = ₹ 1,45,288

₹ 1,45,288 shall be charged as Employee Benefit expense in Statement of Profit and Loss for the year ended 31.03.20X2.

Amortisation table:

Year	Opening balance of Staff Advance (a)	Interest (10%) (b)= (a x 10%)	Repayment (c)	Closing balance of Staff Advance (d) = a + b -c
1	8,54,712	85,471	2,40,000	7,00,183
2	7,00,183	70,018	2,32,000	5,38,201
3	5,38,201	53,820	2,24,000	3,68,021
4	3,68,021	36,802	2,16,000	1,88,823
5	1,88,823	19,177 (b.f.)	2,08,000	*Nil*

Balance Sheet extracts showing the presentation of staff loan as at 31st March, 20X2

Ind AS compliant Division II of Sch III needs to be referred for presentation requirement in Balance Sheet on Ind AS.

Assets **Non-Current Assets** Financial Assets (i) Loan	5,38,201
Current Assets Financial Assets (i) Loans (7,00,183 - 5,38,201)	1,61,982

Case Study 2

Pluto Ltd. has purchased a manufacturing plant for ₹ 6 lakhs on 1st April, 20X1. The useful life of the plant is 10 years. On 30th September, 20X3, Pluto temporarily stops using the manufacturing plant because demand has declined. However, the plant is maintained in a workable condition and it will be used in future when demand picks up.

The accountant of Pluto ltd. decided to treat the plant as held for sale until the demands picks up and accordingly measures the plant at lower of carrying amount and fair value less cost to sell.

Also, the accountant has also stopped charging the depreciation for the rest of period considering the plant as held for sale. The fair value less cost to sell on 30th September, 20X3 and 31st March, 20X4 was ₹ 4 lakhs and ₹ 3.5 lakhs respectively.

The accountant has performed the following working: ₹

Carrying amount on initial classification as held for sale		
Purchase Price of Plant	*6,00,000*	
Less: Accumulated dep (6,00,000/ 10 Years) x 2.5 years	*(1,50,000)*	*4,50,000*
Fair Value less cost to sell as on 31st March, 20X4		*4,00,000*
The value will be lower of the above two		*4,00,000*

Balance Sheet extracts as on 31st March, 20X4

Assets	
Current Assets	
Other Current Assets	
Assets classified as held for sale	*3,50,000*

Analyse whether the above accounting treatment made by the accountant is in compliance with the Ind AS. If not, advise the correct treatment alongwith the necessary workings.

Solution

The above treatment needs to be examined in the light of the provisions given in Ind AS 16 '*Property, Plant and Equipment*' and Ind AS 105 '*Non-current Assets Held for Sale and Discontinued Operations'*.

Para 6 of Ind AS 105 '*Non-current Assets Held for Sale and Discontinued Operations'* states that:

"An entity shall classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use".

Paragraph 7 of Ind AS 105 states that:

"For this to be the case, the asset (or disposal group) must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and its sale must be highly probable. Thus, an asset (or disposal group) cannot be classified as a non-current asset (or disposal group) held for sale, if the entity intends to sell it in a distant future".

Further, paragraph 8 of Ind AS 105 states that:

"For the sale to be highly probable, the appropriate level of management must be committed to a plan to sell the asset (or disposal group), and an active programme to locate a buyer and complete the plan must have been initiated. Further, the asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value. In addition, the sale should

be expected to qualify for recognition as a completed sale within one year from the date of classification and actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn."

Paragraph 13 of Ind AS 105 states that:

"An entity shall not classify as held for sale a non-current asset (or disposal group) that is to be abandoned. This is because its carrying amount will be recovered principally through continuing use."

Paragraph 14 of Ind AS 105 states that:

"An entity shall not account for a non-current asset that has been temporarily taken out of use as if it had been abandoned."

Paragraph 55 of Ind AS 16 states that:

"Depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated."

Going by the guidance given above,

The Accountant of Pluto Ltd. has treated the plant as held for sale and measured it at the fair value less cost to sell. Also, the depreciation has not been charged thereon since the date of classification as held for sale which is not correct and not in accordance with Ind AS 105 and Ind AS 16.

Accordingly, the manufacturing plant should neither be treated as abandoned asset nor as held for sale because its carrying amount will be principally recovered through continuous use. Pluto Ltd. shall not stop charging depreciation or treat the plant as held for sale because its carrying amount will be recovered principally through continuing use to the end of their economic life.

The working of the same for presenting in the balance sheet is given as below:

Calculation of carrying amount as on 31st March, 20X4	
Purchase Price of Plant	6,00,000
Less: Accumulated depreciation (6,00,000/ 10 Years) x 3 Years	(1,80,000)
	4,20,000
Less: Impairment loss	(70,000)
	3,50,000

Balance Sheet extracts as on 31st March, 20X4

Assets	
Non-Current Assets	
Property, Plant and Equipment	3,50,000

Working Note:

Fair value less cost to sell of the Plant = ₹ 3,50,000

Value in Use (not given) or = Nil (since plant has temporarily not been used for manufacturing due to decline in demand)

Recoverable amount = higher of above i.e. ₹ 3,50,000

Impairment loss = Carrying amount – Recoverable amount

Impairment loss = ₹ 4,20,000 - ₹ 3,50,000 = ₹ 70,000.

Case Study 3

On 5th April, 20X2, fire damaged a consignment of inventory at one of the Jupiter's Ltd.'s warehouse. This inventory had been manufactured prior to 31st March, 20X2 costing ₹ 8 lakhs. The net realisable value of the inventory prior to the damage was estimated at ₹ 9.60 lakhs. Because of the damage caused to the consignment of inventory, the company was required to spend an additional amount of ₹ 2 lakhs on repairing and re-packaging of the inventory. The inventory was sold on 15th May, 20X2 for proceeds of ₹ 9 lakhs.

The accountant of Jupiter Ltd treats this event as an adjusting event and adjusted this event of causing the damage to the inventory in its financial statement and accordingly re-measures the inventories as follows: *₹ lakhs*

Cost	*8.00*
Net realisable value (9.6 -2)	*7.60*
Inventories (lower of cost and net realisable value)	*7.60*

Analyse whether the above accounting treatment made by the accountant in regard to financial year ending on 31.0.20X2 is in compliance of the Ind AS. If not, advise the correct treatment alongwith working for the same.

Solution

The above treatment needs to be examined in the light of the provisions given in Ind AS 10 *'Events after the Reporting Period'* and *Ind AS 2 'Inventories'*.

Para 3 of Ind AS 10 *'Events after the Reporting Period'* defines *"Events after the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when 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 for issue. Two types of events can be identified:*

(a) those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period); and

(b) *those that are indicative of conditions that arose after the reporting period (non-adjusting events after the reporting period).*

Further, paragraph 10 of Ind AS 10 states that:

"An entity shall not adjust the amounts recognised in its financial statements to reflect non-adjusting events after the reporting period".

Further, paragraph 6 of Ind AS 2 defines:

"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".

Further, paragraph 9 of Ind AS 2 states that:

"Inventories shall be measured at the lower of cost and net realisable value".

Accountant of Jupiter Ltd. has re-measured the inventories after adjusting the event in its financial statement which is not correct and nor in accordance with provision of Ind AS 2 and Ind AS 10.

Accordingly, the event causing the damage to the inventory occurred after the reporting date and as per the principles laid down under Ind AS 10 '*Events After the Reporting Date*' is a non-adjusting event as it does not affect conditions at the reporting date. Non-adjusting events are not recognised in the financial statements, but are disclosed where their effect is material.

Therefore, as per the provisions of Ind AS 2 and Ind AS 10, the consignment of inventories shall be recorded in the Balance Sheet at a value of ₹ 8 Lakhs calculated below:

₹ lakhs

Cost	8.00
Net realisable value	9.60
Inventories (lower of cost and net realisable value)	8.00

Case Study 4

On 1st April, 20X1, Sun Ltd. has acquired 100% shares of Earth Ltd. for ₹ 30 lakhs. Sun Ltd. has 3 cash-generating units A, B and C with fair value of ₹ 12 lakhs, ₹ 8 lakhs and ₹ 4 lakhs respectively. The company recognizes goodwill of Rs 6 lakhs that relates to CGU 'C' only.

During the financial year 20X2-20X3, the CFO of the company has a view that there is no requirement of any impairment testing for any CGU since their recoverable amount is comparatively higher than the carrying amount and believes there is no indicator of impairment.

Analyse whether the view adopted by the CFO of Sun Ltd is in compliance of the Ind AS. If not, advise the correct treatment in accordance with relevant Ind AS

Solution

The above treatment needs to be examined in the light of the provisions given in Ind AS 36: Impairment of Assets.

Para 9 of Ind AS 36 *'Impairment of Assets'* states that *"An entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset."*

Further, paragraph 10(b) of Ind AS 36 states that:

"Irrespective of whether there is any indication of impairment, an entity shall also test goodwill acquired in a business combination for impairment annually."

Sun Ltd has not tested any CGU on account of not having any indication of impairment is partially correct i.e. in respect of CGU A and B but not for CGU C. Hence, the treatment made by the Company is not in accordance with Ind AS 36.

Accordingly, impairment testing in respect of CGU A and B are not required since there are no indications of impairment. However, Sun Ltd shall test CGU C irrespective of any indication of impairment annually as the goodwill acquired on business combination is fully allocated to CGU 'C'.

TEST YOUR KNOWLEDGE

Questions

1. Venus Ltd. is a multinational entity that owns three properties. All three properties were purchased on 1st April, 20X1. The details of purchase price and market values of the properties are given as follows:

Particulars	Property 1	Property 2	Property 3
	Factory	Factory	Let-Out
Purchase price	15,000	10,000	12,000
Market value 31.03.20X2	16,000	11,000	13,500
Life	10 Years	10 Years	10 Years
Subsequent Measurement	Cost Model	Revaluation Model	Revaluation Model

Property 1 and 2 are used by Venus Ltd. as factory building whilst property 3 is let-out to a non-related party at a market rent. The management presents all three properties in balance sheet as 'property, plant and equipment'.

The Company does not depreciate any of the properties on the basis that the fair values are exceeding their carrying amount and recognise the difference between purchase price and fair value in Statement of Profit and Loss.

Required:

Analyse whether the accounting policies adopted by the Venus Ltd. in relation to these properties is in accordance with Ind AS. If not, advise the correct treatment alongwith working for the same.

2. On 1st January, 20X2, Sun Ltd. was notified that a customer was taking legal action against the company in respect of a financial losses incurred by the customer. Customer alleged that the financial losses were caused due to supply of faulty products on 30th September, 20X1 by the Company. Sun Ltd. defended the case but considered, based on the progress of the case up to 31st March, 20X2, that there was a 75% probability they would have to pay damages of ₹ 10 lakhs to the customer.

However, the accountant of Sun Ltd. has not recorded this transaction in its financial statement as the case is not yet finally settled. The case was ultimately settled against the company resulting in to payment of damages of ₹ 12 lakhs to the customer on 15th May, 20X2. The financials have been authorized by the Board of Directors in its meeting held on 18th May, 20X2.

Analyse whether the above accounting treatment made by the accountant is in compliance of the Ind AS. If not, advise the correct treatment along with working for the same.

3. Mercury Ltd. is an entity engaged in plantation and farming on a large scale diversified across India. On 1st April, 20X1, the company has received a government grant for ₹ 10 lakhs subject to a condition that it will continue to engage in plantation of eucalyptus tree for a coming period of five years.

   The management has a reasonable assurance that the entity will comply with condition of engaging in the plantation of eucalyptus tree for specified period of five years and accordingly it recognises proportionate grant for ₹ 2 lakhs in Statement of Profit and Loss as income following the principles laid down under *Ind AS 20 Accounting for Government Grants and Disclosure of Government Assistance*.

   Analyse whether the above accounting treatment made by the management is in compliance of the Ind AS. If not, advise the correct treatment alongwith working for the same.

4. Mercury Ltd. has sold goods to Mars Ltd. at a consideration of ₹ 10 lakhs, the receipt of which receivable in three equal installments of ₹ 3,33,333 over a two year period (receipts on 1st April, 20X1, 31st March, 20X2 and 31st March, 20X3).

   The company is offering a discount of 5 % (i.e. ₹ 50,000) if payment is made in full at the time of sale. The sale agreement reflects an implicit interest rate of 5.36% p.a.

   The total consideration to be received from such sale is at ₹ 10 Lakhs and hence, the management has recognised the revenue from sale of goods for ₹ 10 lakhs. Further, the management is of the view that there is no difference in this aspect between Indian GAAP and Ind AS.

   Analyse whether the above accounting treatment made by the accountant is in compliance of the Ind AS. If not, advise the correct treatment along with working for the same.

Answers

1. The above issue needs to be examined in the umbrella of the provisions given in Ind AS 1 ‘*Presentation of Financial Statements’,* Ind AS 16 *‘Property, Plant and Equipment’* in relation to property ‘1’ and ‘2’ and *Ind AS 40 ‘Investment Property’* in relation to property ‘3’.

   Property ‘1’ and ‘2’

   Para 6 of Ind AS 16 ‘*Property, Plant and Equipment’* defines:

   “Property, plant and equipment are tangible items that:

   (a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

   (b) are expected to be used during more than one period.”

Paragraph 29 of Ind AS 16 states that:

"An entity shall choose either the cost model or the revaluation model as its accounting policy and shall apply that policy to an entire class of property, plant and equipment".

Further, paragraph 36 of Ind AS 16 states that:

"If an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued".

Further, paragraph 39 of Ind AS 16 states that:

"If an asset's carrying amount is increased as a result of a revaluation, the increase shall be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss".

Further, paragraph 52 of Ind AS 16 states that:

"Depreciation is recognised even if the fair value of the asset exceeds its carrying amount, as long as the asset's residual value does not exceed its carrying amount".

Property '3'

Para 6 of Ind AS 40 '*Investment property'* defines:

"Investment property is property (land or a building—or part of a building—or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes; or

(b) sale in the ordinary course of business".

Further, paragraph 30 of Ind AS 40 states that:

"An entity shall adopt as its accounting policy the cost model to all of its investment property".

Further, paragraph 79 (e) of Ind AS 40 requires that:

"An entity shall disclose the fair value of investment property".

Further, paragraph 54 (2) of Ind AS 1 '*Presentation of Financial Statements'* requires that:

"As a minimum, the balance sheet shall include line items that present the following amounts:

(a) property, plant and equipment;

(b) investment property;

As per the facts given in the question, Venus Ltd. has

(a) presented all three properties in balance sheet as 'property, plant and equipment';

(b) applied different accounting policies to Property '1' and '2';

(c) revaluation is charged in statement of profit and loss as profit; and

(d) applied revaluation model to Property '3' being classified as Investment Property.

These accounting treatment is neither correct nor in accordance with provision of Ind AS 1, Ind AS 16 and Ind AS 40.

Accordingly, Venus Ltd. shall apply the same accounting policy (i.e. either revaluation or cost model) to entire class of property being property '1' and '2". It also required to depreciate these properties irrespective of that, their fair value exceeds the carrying amount. The revaluation gain shall be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus.

There is no alternative of revaluation model in respect to property '3' being classified as Investment Property and only cost model is permitted for subsequent measurement. However, Venus ltd. is required to disclose the fair value of the property in the Notes to Accounts. Also the property '3' shall be presented as separate line item as Investment Property.

Therefore, as per the provisions of Ind AS 1, Ind AS 16 and Ind AS 40, the presentation of these three properties in the balance sheet is as follows:

Case 1: Venus Ltd. has applied the Cost Model to an entire class of property, plant and equipment.

Balance Sheet extracts as at 31st March, 20X2 ₹

Assets		
Non-Current Assets		
Property, Plant and Equipment		
Property '1'	13,500	
Property '2'	9,000	22,500
Investment Properties		
Property '3'		10,800

Case 2: Venus Ltd. has applied the Revaluation Model to an entire class of property, plant and equipment.

Balance Sheet extracts as at 31st March, 20X2 ₹

Assets		
Non-Current Assets		
Property, Plant and Equipment		
Property '1'	16,000	

Property '2'	11,000	27,000
Investment Properties		
Property '3'		10,800
Equity and Liabilities		
Other Equity		
Revaluation Reserve		
Property '1'	2,500	
Property '2'	2,000	4,500

The revaluation reserve should be routed through Other Comprehensive Income (subsequently not reclassified to Profit and Loss) in Statement of Profit and Loss and Shown as a separate column in Statement of Changes in Equity.

2. The above treatment needs to be examined in the light of the provisions given in Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets' and Ind AS 10 'Events After the Reporting Period'.

Para 10 of Ind AS 37 *'Provisions, Contingent Liabilities and Contingent Assets'* defines:

"Provision is a liability of uncertain timing or amount.

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

Further, paragraph 14 of Ind AS 37, states:

"A provision shall be recognised when:

(a) an entity has a present obligation (legal or constructive) as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation".

Further, paragraph 36 of Ind AS 37, states:

"The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period".

Further, paragraph 3 of Ind AS 10 *'Events after the Reporting Period'* defines:

"Events after the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when 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 for issue. Two types of events can be identified:

(a) those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period); and

(b) those that are indicative of conditions that arose after the reporting period (non-adjusting events after the reporting period).

Further, paragraph 8 of Ind AS 10 states that:

"An entity shall adjust the amounts recognised in its financial statements to reflect adjusting events after the reporting period."

The Accountant of Sun Ltd. has not recognised the provision and accordingly not adjusted the amounts recognised in its financial statements to reflect adjusting events after the reporting period is not correct and nor in accordance with provision of Ind AS 37 and Ind AS 10.

As per given facts, the potential payment of damages to the customer is an obligation arising out of a past event which can be reliably estimated. Therefore, following the provision of Ind AS 37 '*Provisions, Contingent Liabilities and Contingent Assets'* – a provision is required. The provision should be for the best estimate of the expenditure required to settle the obligation at 31st March, 20X2 which comes to ₹ 7.5 lakhs (₹ 10 lakhs x 75%).

Further, following the principles of Ind AS 10 '*Events After the Reporting Period'* evidence of the settlement amount is an adjusting event. Therefore, the amount of provision created shall be increased to ₹ 12 lakhs and accordingly be recognised as a current liability.

3. As per given facts, the company is engaged in plantation and farming. Hence Ind AS 41 Agriculture shall be applicable to this company.

The above facts need to be examined in the light of the provisions given in *Ind AS 20* '*Accounting for Government Grants and Disclosure of Government Assistance'* and *Ind AS 41 'Agriculture'.*

Para 2(d) of Ind AS 20 *'Accounting for Government Grants and Disclosure of Government Assistance'* states:

"This Standard does not deal with government grants covered by Ind AS 41, Agriculture".

Further, paragraph 1 (c) of Ind AS 41 *'Agriculture'*, states:

"This Standard shall be applied to account for the government grants covered by paragraphs 34 and 35 when they relate to agricultural activity".

Further, paragraph 1 (c) of Ind AS 41 *'Agriculture'*, states:

"If a government grant related to a biological asset measured at its fair value less costs to sell is conditional, including when a government grant requires an entity not to engage in specified agricultural activity, an entity shall recognise the government grant in profit or loss when, and only when, the conditions attaching to the government grant are met".

Understanding of the given facts, The Company has recognised the proportionate grant for ₹ 2 lakhs in Statement of Profit and Loss before the conditions attaching to government grant are met which is not correct and nor in accordance with provision of Ind AS 41 *'Agriculture'*.

Accordingly, the accounting treatment of government grant received by the Mercury Ltd. is governed by the provision of Ind AS 41 *'Agriculture'* rather Ind AS 20 *'Accounting for Government Grants and Disclosure of Government Assistance'*.

Government grant for ₹ 10 lakhs shall be recognised in profit or loss when, and only when, the conditions attaching to the government grant are met i.e. after the expiry of specified period of five years of continuing engagement in the plantation of eucalyptus tree.

Balance Sheet extracts showing the presentation of Government Grant as on 31st March, 20X2 ₹

Liabilities	
Non-Current liabilities Other Non-Current Liabilities Government Grants	10,00,000

4. The revenue from sale of goods shall be recognised at the fair value of the consideration received or receivable. The fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest where the receipt is deferred beyond normal credit terms. The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue.

The fair value of consideration (cash price equivalent) of the sale of goods is calculated as follows: ₹

Year	Consideration (Installment)	Present value factor	Present value of consideration
Time of sale	3,33,333	-	3,33,333
End of 1st year	3,33,333	0.949	3,16,333
End of 2nd year	3,33,334	0.901	3,00,334
	10,00,000		**9,50,000**

The Company that agrees for deferring the cash inflow from sale of goods will recognise the revenue from sale of goods and finance income as follows:

Initial recognition of sale of goods		₹	₹
Cash	Dr.	3,33,333	
Trade Receivable	Dr.	6,16,667	
To Sale			9,50,000
Recognition of interest expense and receipt of second installment			
Cash	Dr.	3,33,333	
To Interest Income			33,053
To Trade Receivable			3,00,280
Recognition of interest expense and payment of final installment			
Cash	Dr.	3,33,334	
To Interest Income (Balancing figure)			16,947
To Trade Receivable			3,16,387

Balance Sheet (extracts) as at 31st March, 20X2 and 31st March, 20X3

₹

	As at 31st March, 20X2	As at 31st March, 20X3
Income		
Sale of Goods	9,50,000	-
Other Income (Finance income)	33,0532,999	16,947

Statement of Profit and Loss (extracts)

for the year ended 31st March, 20X2 and 31st March, 20X3

₹

	As at 31st March, 20X2	As at 31st March, 20X3
Assets		
Current Assets		
Financial Assets		
Trade Receivables	3,16,387	XXX

CHAPTER 16

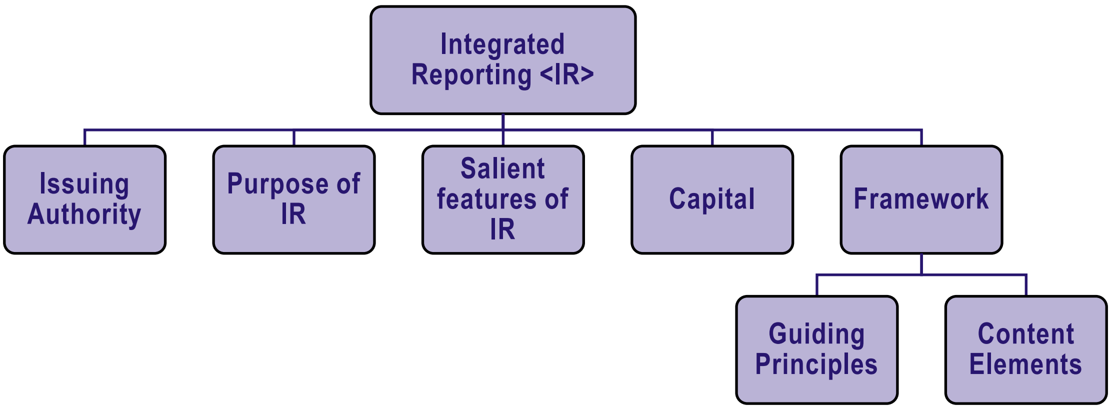
INTEGRATED REPORTING

LEARNING OUTCOMES

After studying this chapter, you would be able to

- ❑ Understand the authority issuing Framework of Integrated Reporting
- ❑ Examine the purpose and objective of Integrated reporting.
- ❑ Analyse integrated reporting as better reporting tool by examining and applying guiding principles and content elements of integrated reporting

CHAPTER OVERVIEW



1. INTRODUCTION

In the last few decades, the concept of value is slowly and gradually shifting from price based or market value of an entity to asset based whether it is tangible or intangible assets. Since the dynamics of the global economy are changing, today's organizations require to assess the value created over the time by actively managing a wider range of resources. Resources like intangible assets such as intellectual capital, research and development, brand value, natural and human capital have become as important as tangible assets in many industries. However, these intangible assets are not universally assessed in current financial reporting frameworks even though they often represent a substantial portion of market value.

2. ORGANISATIONAL STRUCTURE/ ISSUING AUTHORITY

Integrated Reporting (<IR>) is a concept first introduced in South Africa. Later on, this concept travelled to many countries like German, France, Spain, Brazil and UK and integrated reporting was made along with their financial statements in one or the other manner. In 2010, the International Integrated Reporting Council (IIRC) was set up which aims to create the globally accepted integrated reporting framework.

The International Integrated Reporting Council (IIRC) is a global coalition of:

- Regulators
- Investors
- Companies
- Standard setters
- The accounting profession and NGOs

Together, this coalition shares the view that **communication about value creation** should be the next step in the evolution of corporate reporting. With this purpose they issued the International Integrated Reporting (IR) Framework. The framework has been developed keeping in mind the greater flexibility to be given to the entity and the management in the reporting but at the same time should target to report the value created by the organisation through various capital.

Integrated Reporting as the name suggest will integrate both financial and non- financial information. In future, it will become the only report to be issued by the organisation.

3. WHAT IS INTEGRATED REPORTING <IR>?

Integrated reporting is a concept that has been created to better articulate the broader range of measures that contribute to long-term value and the role organizations play in society. Integrated Reporting is enhancing the way organizations think, plan and report the story of their business. Central to this is the proposition that value is increasingly shaped by factors additional to financial performance, such as reliance on the environment, social reputation, human capital skills and others.

This value creation concept is the backbone of integrated reporting and is the direction for the future of corporate reporting. In addition to financial capital, integrated reporting examines five additional capitals that should guide an organization's decision-making and long-term success — its value creation in the broadest sense.

> "Integrated Reporting reflects how our company thinks and does business. This approach allows us to discuss material issues facing our business and communities and show how we create value, for shareholders and for society as a whole." **Dimitris Lois, CEO, Coca-Cola HBC**

Organizations are using <IR> to communicate a clear, concise, integrated story that explains how all of their resources are creating value. <IR> is helping businesses to think holistically about their strategy and plans, make informed decisions and manage key risks to build investor and stakeholder confidence and improve future performance.

Integrated Reporting (<IR>) promotes a more cohesive and efficient approach to corporate reporting and aims to improve the quality of information available to providers of financial capital to enable a more efficient and productive allocation of capital.

Integrated Reporting (<IR>) is shaped by a diverse coalition including business leaders and investors to drive a global evolution in corporate reporting.

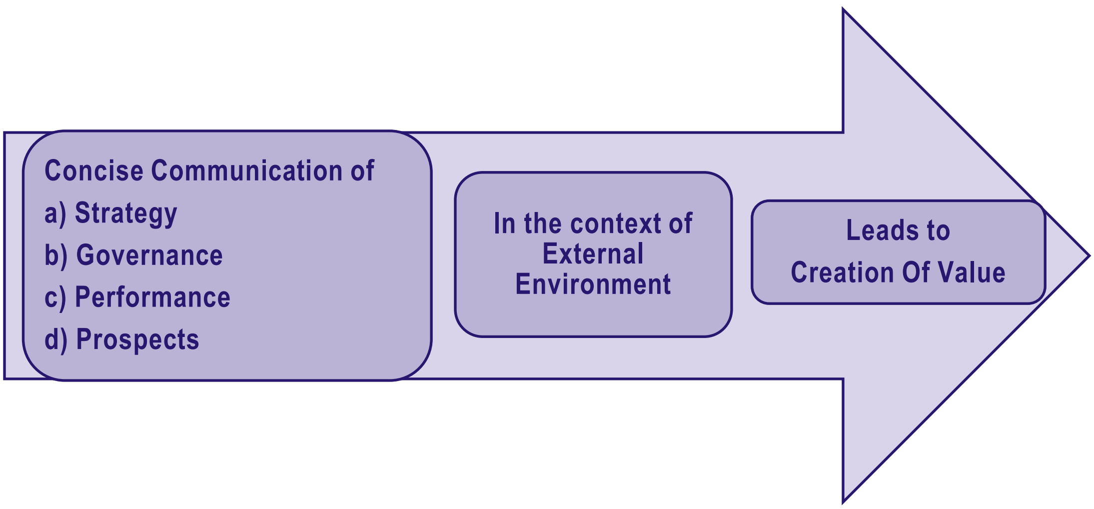
An integrated report is a **concise communication** about how an organization's:

- Strategy
- Governance
- Performance And
- Prospects

in the context of its **external environment**

It leads to the **creation of value** over:

- Short
- Medium And
- Long term



It's a portal by which the organisation communicates a holistic view of:

- Its Current position
- Where it's going And
- How it intends to get there

The report enables readers to make an assessment of the organisation's ability to create value in the future, with value creation referring to the value created for both the organisation and for others.

4. PURPOSE OF INTEGRATED REPORTING

The primary purpose of an integrated report is to explain to providers of financial capital how an organization creates value over time.

An integrated report benefits all stakeholders interested in an organization's ability to create value over time, including:

- Employees
- Customers
- Suppliers
- Business partners
- Local communities
- Legislators
- Regulators and
- Policy-makers

5. SALIENT FEATURES OF INTEGRATED REPORTING FRAMEWORK

5.1 Principle Based Approach

The International <IR> Framework (the Framework) takes a principles-based approach. This Framework identifies information to be included in an integrated report for use in assessing an organization's ability to create value; it does not set benchmarks for such things as the quality of an organization's strategy or the level of its performance.

It intent to strike an appropriate balance between flexibility and prescription that recognizes the wide variation in individual circumstances of different organizations while enabling a sufficient degree of comparability across organizations to meet relevant information needs.

5.2 Targets the Private Sector or Profit Making Companies

This Framework is written primarily in the context of private sector, for-profit companies of any size but it can also be applied, adapted as necessary, by public sector and not-for-profit organizations.

5.3 Identifiable Communication

An integrated report may be prepared in response to existing compliance requirements, and may be either a standalone report or be included as a distinguishable, prominent and accessible part of another report or communication. It should include, transitionally on a comply or explain basis, a statement by those charged with governance accepting responsibility for the report.

An integrated report is intended to be more than a summary of information in other communications (e.g., financial statements, a sustainability report, analyst calls, or on a website); rather, it makes explicit the connectivity of information to communicate how value is created over time.

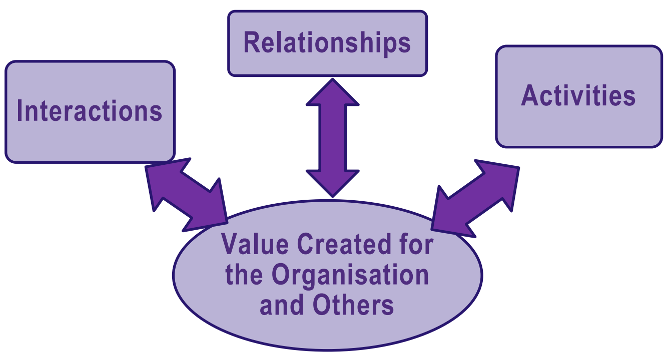
5.4 Financial and Non-financial Items

The primary purpose of an integrated report is to explain to providers of financial capital how an organization creates value over time. It, therefore, contains relevant information, both financial and other.

5.5 Value Creation

Value created by an organization over time manifests itself in increases, decreases or transformations of the capitals caused by the organization's business activities and outputs. That value has two interrelated aspects – value created for:

- The organization itself, which enables financial returns to the providers of financial capital
- Others (i.e., stakeholders and society at large)



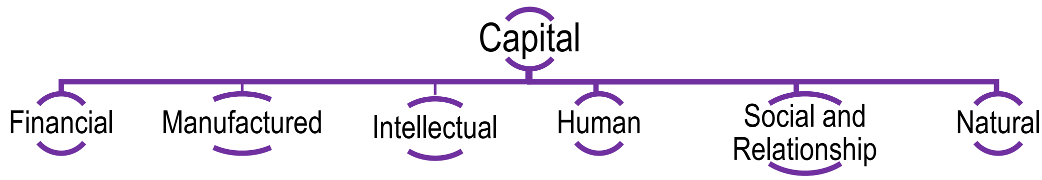
6. THE CAPITALS

The capitals are stocks of value that are increased, decreased or transformed through the activities and outputs of the organization.

This is interrelated with the value the organization creates for stakeholders and society at large through a wide range of activities, interactions and relationships. When these are material to the organization's ability to create value for itself, they are included in the integrated report.

The concept of capitals seeks to assist an organisation in identifying all the resources and relationships it uses and affects to report in a comprehensive manner.

The Framework has categorise the capital into 6 main forms. However, at the same time, it stresses upon that not necessary the same categorisation of capital be followed by the entities in their integrated reporting.



6.1 Financial Capital

The pool of funds

- available to an organization for use in the production of goods or the provision of services
- obtained through financing, such as:
  - Debt, equity or grants; or
  - Generated through operations or investments

6.2 Manufactured Capital

Manufactured physical objects (as distinct from natural physical objects) that are available to an organization for use in the production of goods or the provision of services, including:

- Buildings
- Equipment
- Infrastructure (such as roads, ports, bridges, and waste and water treatment plants)

Note: Manufactured capital is often created by other organizations, but includes assets manufactured by the reporting organization for sale or when they are retained for its own use.

6.3 Intellectual Capital

Organizational, knowledge-based intangibles, including:

- Intellectual property, such as patents, copyrights, software, rights and licences
- "Organizational capital" such as tacit knowledge, systems, procedures and protocols

6.4 Human Capital

People's competencies, capabilities and experience, and their motivations to innovate, including their:

- Alignment with and support for an organization's governance framework, risk management approach, and ethical values
- Ability to understand, develop and implement an organization's strategy
- Loyalties and motivations for improving processes, goods and services, including their ability to lead, manage and collaborate

6.5 Social and Relationship Capital

The institutions and the relationships within and between communities, groups of stakeholders and other networks, and the ability to share information to enhance individual and collective well-being.

Social and relationship capital includes:

- Shared norms, and common values and behaviours
- Key stakeholder relationships, and the trust and willingness to engage that an organization has developed and strives to build and protect with external stakeholders
- Intangibles associated with the brand and reputation that an organization has developed
- An organization's social licence to operate

6.6 Natural Capital

All renewable and non-renewable environmental resources and processes that provide goods or services that support the past, current or future prosperity of an organization.

It includes:

- Air, water, land, minerals and forests
- Biodiversity and eco-system health

> **Note:** Not all capitals are equally relevant or applicable to all organizations. While most organizations interact with all capitals to some extent, these interactions might be relatively minor or so indirect that they are not sufficiently important to include in the integrated report.

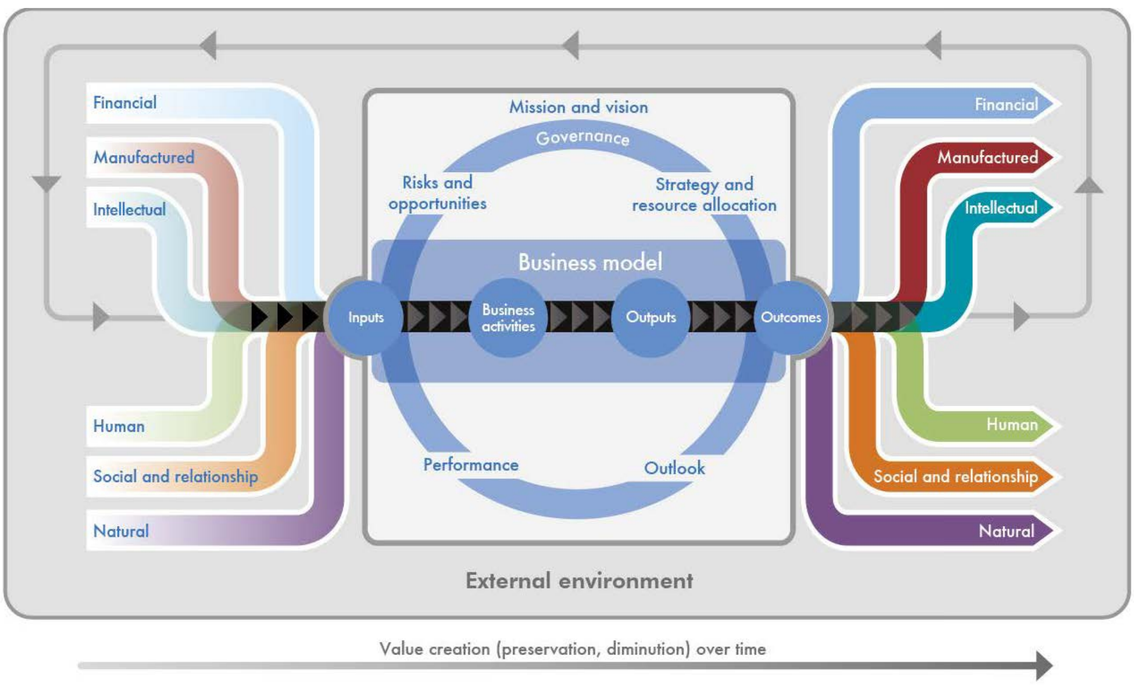
7. CONTRIBUTION OF CAPITALS IN VALUE CREATION

The stock of capitals available to the organization are increased, decreased or transformed as a result of the value it is creating through various activities.

The connectivity and interdependence among the various capitals or inputs — specifically their influence on the organization's long-term financial performance — should be communicated in an integrated report.

The capitals not only interact with each other, but they are also influenced by external factors. These include the economic climate, technological progress, social changes and environmental issues. Many a times, the capitals become an internally generated intangible asset.

To understand how an organization uses its capitals, how they relate to each other and the influence of external factors, it's vital to define the strategy, and a series of KPIs, to measure the strategy's progress.



(Source of the above diagram: Framework of IR issued by IIRC)

8. GUIDING PRINCIPLES FOR PREPARATION AND PRESENTATION OF INTEGRATED REPORT

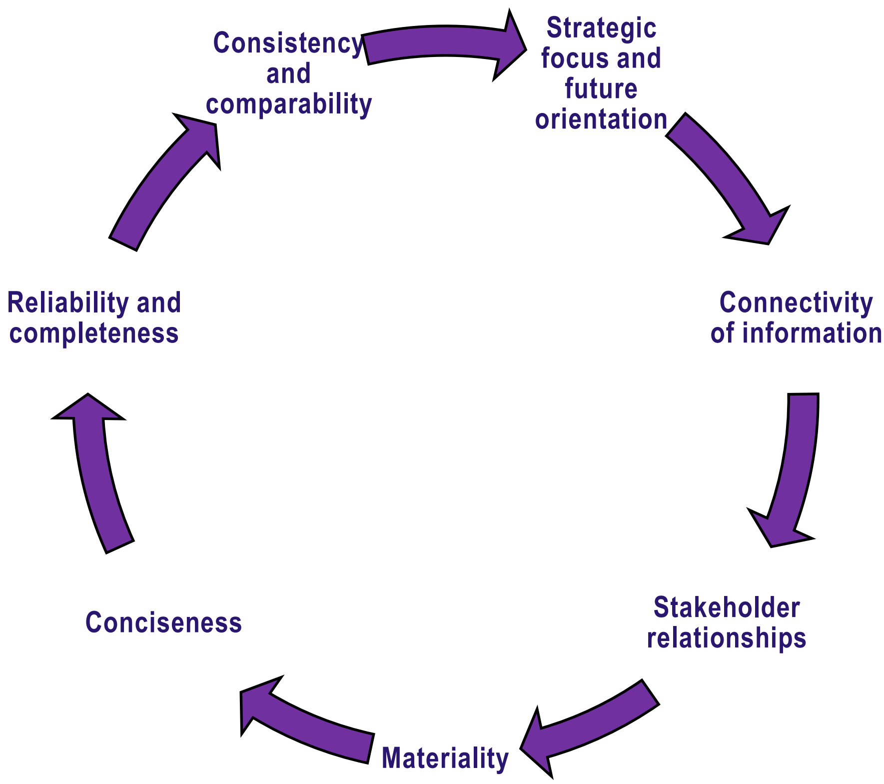
One of the distinguishing features of Integrated Reporting is that in contrast to compliance based reporting, there can be no model report.

Every report must be built around the unique business model of the preparer. This requires a very different mind -set when looking at examples of good reporting.

There are many good illustrations of how to report specific matters but examples can only provide a starting point for a company's own reporting, not a template.

The starting point for understanding how Integrated Reporting works is considering the application of the **content elements and guiding principles** of the IIRC's Integrated Reporting framework.

The following Guiding Principles underpin the preparation and presentation of an integrated report, informing the content of the report and how information is presented:



8.1 Strategic Focus and Future Orientation

An integrated report should provide:

- Insight into the organization's strategy and
- How it relates to the organization's ability

  to create value and to its use of and effects on the capitals in:

  - Short
  - Medium and
  - Long term
- An integrated report should answer the question that where does the organization wants to go and how does it intend to get there?
- The report should clearly show the linkages between strategy, risks and opportunities, current performance, as well as future outlook and targets.

Extract of ABC LTD Sustainability Report Year 2016

Building Natural Achievements and Social Capital

ABC's vision of sustainable and inclusive growth has led to the adoption of a Triple Bottom Line approach that simultaneously builds economic, social and environmental capital.

It's Social Investment Programmes, including Social Forestry, Soil & Moisture Conservation, Sustainable Agriculture, Livestock Development, Biodiversity, Women Empowerment, Education, Skilling & Vocational Training and Health & Sanitation, have had a transformational impact on rural India.

These Programmes strive to empower stakeholder communities to conserve, manage and augment their natural resources, create sustainable on and off-farm livelihood sources and improve social infrastructure in rural areas.

Through its Businesses and associated value chains, ABC has supported the generation of around 6 million livelihoods, touching the lives of many living at the margins in rural India. In line with its commitment to environmental goals, ABC has constantly strived to reduce the impact of its Businesses, processes, products and services and create a positive footprint.

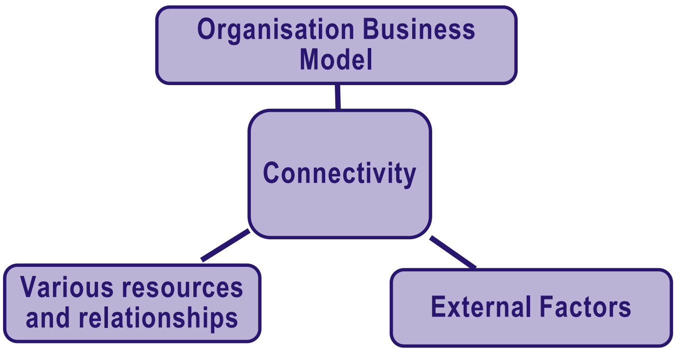
ABC has adopted a low-carbon growth strategy through reduction in specific energy consumption and enhancing use of renewable energy sources.

ABC also endeavours to reduce specific water consumption and augment rainwater harvesting activities both on site and off site at watershed catchment areas, as well as minimise waste generation, maximise reuse & recycling and use external post-consumer waste as raw material in its units.

8.2 Connectivity of Information

An integrated report shows the connections between the different components:

- Organisation's business model
- External factors that affect the organisation
- Various resources and relationships on which the organisation and its performance are dependent upon



Note: The report should highlight the connection, for example, between past, present and future performance, between financial and non-financial information, and between qualitative and quantitative information.

Sample Report

Schiphol Group Company – An Extract

Mission

We aim to rank among the world's leading airport companies. We create sustainable value for our stakeholders by developing Airport Cities and by positioning Amsterdam Airport Schiphol as Europe's preferred airport. Schiphol ranks among the most efficient transport hubs for air, rail and road connections and offers its visitors and the businesses located at Schiphol the services they require 24 hours a day, seven days a week.

Profile

XYZ Group is an airport operator, focusing particularly on Airport Cities. A prime example of an Airport City is Amsterdam Airport Schiphol. Europe's fifth-largest airport in terms of passengers and third-largest in terms of cargo.

In addition to our Dutch operations (Amsterdam Airport Schiphol, Rotterdam The Hague Airport, Eindhoven Airport and Lelystad Airport), we have direct and indirect operations in the United States, Australia, Italy, Indonesia, Aruba and Sweden.

Activities

The operation of airport and development of airport cities involve 3 inextricably linked business areas: Aviation, Consumers and Real Estate. The integrated activities of Aviation, Consumers and Real Estate form the core of the Airport City concept. This concept is not only applied to Amsterdam Airport Schiphol but also – either in part or in full – to other airports, particularly through the Alliances & Participations business area. Our revenues derived from this broad range of activities are made up for the most part of airport charges, concession fees, parking fees, retail sales, rents and leases, and income from our international activities.

Amsterdam Airport Schiphol is an important contributor to the Dutch economy. It serves as one of the home bases for Air France-KLM and its SkyTeam partners, from which these airlines serve their European and intercontinental destinations. Amsterdam Airport Schiphol offers a high-quality network serving 301 destinations.

Strategy

The maintenance and reinforcement of the Main Port's competitive position, and that of Amsterdam Airport Schiphol in particular, is the single most important objective on which our strategy is focused. This strategy combines the airport's socio-economic function with our entrepreneurial business operations.

The interconnection and interaction between these two elements are crucial for the robust and future-proof development of Schiphol Group going forward. Corporate Responsibility is an integral part of this strategy and has been permeating increasingly all aspects of our operations.

Stakeholders

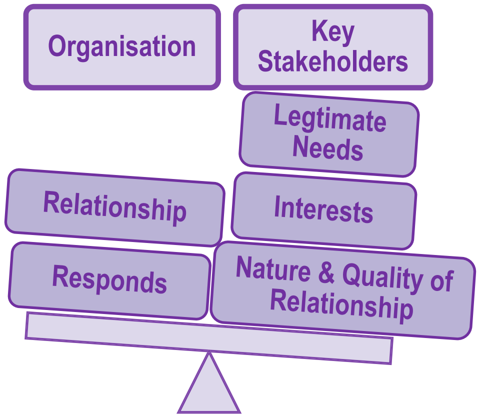
Schiphol Group has many stakeholders and their interests can be quite divergent. We do our utmost to conduct an active dialogue with all our stakeholders. In this, and in everything else that we do, our core values play a key role: reliability, efficiency, hospitality, inspiration and sustainability. Achieving the ambition to be Europe's preferred airport calls for a culture driven by a desire to fulfil or, better yet, surpass the expectations of customers and local stakeholders.

8.3 Stakeholder Relationships

An integrated report should provide insight into:

- Nature and Quality of the organization's relationships with its
- Key stakeholders

including how and to what extent the organization understands, takes into account and responds to their legitimate needs and interests.



8.4 Materiality

An integrated report should disclose information about matters that substantively affect the organization's ability to create value over:

- Short
- Medium
- Long term

Note: A focus on materiality should assist in avoiding irrelevant and detailed information from cluttering the report. The integrated report is a high-level, concise report that contains only the most material matters and information affecting the organisation and its ability to create value over time. Additional information can be placed in supporting reports.

8.5 Conciseness

An integrated report should be concise.

Note: Conciseness implies more than 'as short as possible'. It implies that the information should be accessible through crisp presentation, the omission of immaterial information, and a logical easy-to-follow structure.

8.6 Reliability and Completeness

An integrated report should include all material matters, **both positive and negative**, in a balanced way and without material error.

Note: Integrated reporting requires that consideration is given to both good and bad news and performance. Furthermore, both the increases and reductions in the value of the important capitals should be reflected. Where the information is not perfectly accurate, estimates should be used and appropriate processes in place to ensure that the risk of material misstatement is reduced.

8.7 Consistency and Comparability

The information in an integrated report should be presented:

- On a basis that is consistent over time.
- In a way that enables comparison with other organizations to the extent it is material to the organization's own ability to create value over time.

Note: The use of industry benchmarks, indicators of best practice, and ratios are tools that can improve reporting consistency and industry comparability.

9. CONTENTS OF INTEGRATED REPORTING

An integrated report includes the eight Content Elements.

The Content Elements are fundamentally linked to each other and are not mutually exclusive. The order of the Content Elements is not the only way they could be sequenced.

The Content Elements are not intended to serve as a standard structure for an integrated report with information about them appearing in a set sequence or as isolated, standalone sections. Rather, information in an integrated report is presented in a way that makes the connections between the Content Elements apparent.

The content of an organization's integrated report will depend on the individual circumstances of the organization. The Content Elements are therefore stated in the form of questions rather than as checklists of specific disclosures. Accordingly, judgement needs to be exercised in applying the Guiding Principles to determine what information is reported, as well as how it is reported.

The eight content elements suggested by the Framework are:

9.1 Organisational Overview and External Environment

Question to be answered through this element in the integrated reporting is

"What does the organisation do and what are the circumstances under which it operates?"

9.1.1 Organisational Overview

An integrated report identifies the organization's mission and vision, and provides essential context by identifying matters such as:

A. The organization's:

- Culture, ethics and values
- Ownership and operating structure
- Principal activities and markets
- Competitive landscape and market positioning (considering factors such as the threat of new competition and substitute products or services, the bargaining power of customers and suppliers, and the intensity of competitive rivalry)
- Position within the value chain

B. KQI: Key quantitative information

Example:

- Number of employees
- Revenue
- Number of countries in which the organization operates
- Highlighting, in particular, significant changes from prior periods

C. Significant factors

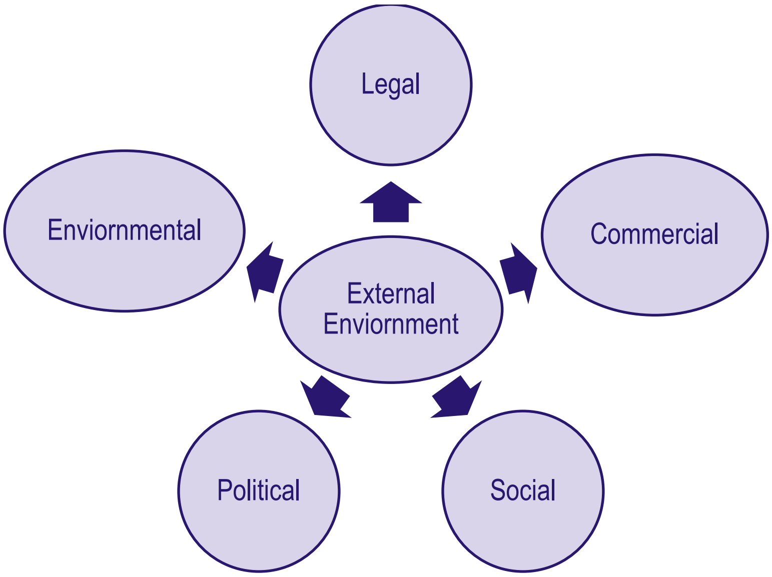
- Significant factors affecting the external environment and the organization's response

9.1.2 External Environment

Significant factors affecting the external environment include aspects of:

- Legal
- Commercial
- Social
- Environmental
- Political context

That affects the organization's ability to create value in the short, medium or long term



Note:	They can affect the organization directly or indirectly (e.g., by influencing the availability, quality and affordability of a capital that the organization uses or affects).

9.2 Governance

Question to be answered through this element in the integrated reporting is

"How does the organisation's governance structure support its ability to create value in the short, medium and long term?"

An integrated report provides insight about how such matters as the following are linked to its **ability to create value:**

- The **organization's leadership structure**, including the skills and diversity (e.g., range of backgrounds, gender, competence and experience) of those charged with governance and whether regulatory requirements influence the design of the governance structure.
- **Specific processes** used to make strategic decisions and to establish and monitor the culture of the organization, including its attitude to risk and mechanisms for addressing integrity and ethical issues
- **Particular actions** those charged with governance have taken to influence and monitor the strategic direction of the organization and its approach to risk management
- How the **organization's culture, ethics and values** are reflected in its use of and effects on the capitals, including its relationships with key stakeholders
- Whether the organization is **implementing governance practices** that exceed legal requirements

- The **responsibility** those charged with governance take for promoting and enabling innovation
- How **remuneration and incentives are linked to value creation** in the short, medium and long term, including how they are linked to the organization's use of and effects on the capitals.

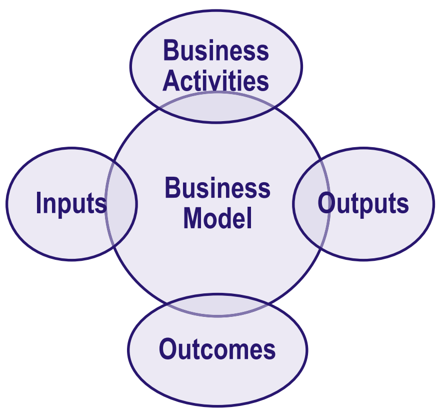
9.3 Business Model

Question to be answered through this element in the integrated reporting is

"What is the organisation's business model?"

An integrated report describes the business model, including key:

- Inputs
- Business activities
- Outputs
- Outcomes



9.3.1 Inputs

An integrated report shows how key inputs relate to the capitals on which the organization depends, or that provide a source of differentiation for the organization, to the extent they are material to understanding the robustness and resilience of the business model.

9.3.2 Business Activities

An integrated report describes key business activities. This can include:

- How the organization differentiates itself in the market place?

Example
Through product differentiation, market segmentation, delivery channels and marketing

- The extent to which the business model relies on revenue generation after the initial point of sale

  Example
  Extended warranty arrangements or network usage charges

- How the organization approaches the need to innovate?
- How the business model has been designed to adapt to change?

9.3.3 Outputs

An integrated report identifies an organization's key products and services. There might be other outputs, such as by-products and waste (including emissions), that need to be discussed within the business model disclosure depending on their materiality.

9.3.4 Outcomes

An integrated report describes key outcomes, including:

- Both internal outcomes (e.g., employee morale, organizational reputation, revenue and cash flows) and external outcomes (e.g., customer satisfaction, tax payments, brand loyalty, and social and environmental effects)
- Both positive outcomes (i.e., those that result in a net increase in the capitals and thereby create value) and negative outcomes (i.e., those that result in a net decrease in the capitals and thereby diminish value).

9.4 Risks and Opportunities

Question to be answered through this element in the integrated reporting is

"What are the specific risks and opportunities that affect the organisation's ability to create value over the short, medium and long-term, and how is the organisation dealing with them?"

An integrated report identifies the key risks and opportunities that are specific to the organization, including those that relate to the organization's effects on, and the continued availability, quality and affordability of, relevant capitals in the short, medium and long term.

9.5 Strategy and Resource Allocation

Question to be answered through this element in the integrated reporting is

"Where does the organisation want to go and how does it intend to get there?"

An integrated report ordinarily identifies:

- The organization's short, medium and long term strategic objectives
- The strategies it has in place, or intends to implement, to achieve those strategic objectives
- The resource allocation plans it has to implement its strategy
- How it will measure achievements and target outcomes for the short, medium and long term.

9.6 Performance

Question to be answered through this element in the integrated reporting is

"To what extent has the organisation achieved its strategic objectives for the period and what are its outcomes in terms of effects on the capitals?"

An integrated report contains qualitative and quantitative information about performance that may include matters such as:

- **Quantitative indicators** with respect to targets and risks and opportunities, explaining their significance, their implications, and the methods and assumptions used in compiling them
- The **organization's effects (both positive and negative) on the capitals**, including material effects on capitals up and down the value chain
- The **state of key stakeholder relationships** and how the organization has responded to key stakeholders' legitimate needs and interests
- The **linkages between past and current performance**, and between current performance and the organization's outlook

9.7 Outlook

Question to be answered through this element in the integrated reporting is

"What challenges and uncertainties is the organisation likely to encounter in pursuing its strategy, and what are the potential implications for its business model and future performance?"

An integrated report ordinarily highlights anticipated changes over time and provides information, built on sound and transparent analysis, about:

- The **organization's expectations** about the external environment the organization is likely to face in the short, medium and long term
- How that will **affect** the organization
- How the **organization is currently equipped** to respond to the critical challenges and uncertainties that are likely to arise.

9.8 Basis of Preparation and Presentation

Question to be answered through this element in the integrated reporting is

"How does the organization determine what matters to include in the integrated report and how are such matters quantified or evaluated?"

An integrated report describes its basis of preparation and presentation, including:

- A summary of the organization's
  - Materiality determination process
- A description of:
  - Reporting boundary and how it has been determined
- A summary of
  - Significant frameworks and methods used to quantify or evaluate material matters

9.9 General Reporting Guidance

The following general reporting matters are relevant to various Content Elements:

- Disclosure of Material matters
- Disclosures about Capitals
- Time frames for short, medium and long term
- Aggregation and disaggregation

10. INTERNATIONAL ACCOUNTING STANDARDS BOARD LOOKING AT THE ROLE OF WIDER REPORTING

The International Accounting Standards Board (IASB) as part of its 'better communication' work is studying and consulting on wider corporate reporting, including developments in Integrated Reporting, as it considers the role the IASB may take going forward.

One possibility is that the IASB might consider a project to revise and update its existing Practice Statement Management Commentary.

Businesses that are looking to communicate a broader story of value creation can use the International IR Framework alongside IFRS.

11. SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

SEBI vide its circular no. SEBI/HO/CFD/CMD/CIR/P/2017/10 February 6, 2017 has advised top 500 companies [to whom Business Responsibility Report ('BRR') have been mandated under Regulation 34(2)(f) of SEBI (Listing Obligations and Disclosure Requirements) Regulations 2015 ("SEBI LODR")], to adopt Integrated Reporting on a voluntary basis from the financial year 2017-18.

The objective behind recommending voluntary adoption of Integrated Reporting is to improve disclosure standards. An integrated report aims to provide a concise communication about how an organisation's strategy, governance, performance and prospects create value over time so that interested stakeholders may make investment decisions accordingly. Today an investor seeks both financial as well as non-financial information to take a well-informed investment decision.

Therefore, towards the objective of improving disclosure standards, in consultation with industry bodies and stock exchanges, the listed entities are advised to adhere to the following:

(a) The information related to Integrated Reporting may be provided in the annual report separately or by incorporating in Management Discussion & Analysis or by preparing a separate report (annual report prepared as per IR framework).

(b) In case the company has already provided the relevant information in any other report prepared in accordance with national/international requirement / framework, it may provide appropriate reference to the same in its Integrated Report so as to avoid duplication of information.

(c) As a green initiative, the companies may host the Integrated Report on their website and provide appropriate reference to the same in their Annual Report.

TEST YOUR KNOWLEDGE

Questions

1. State the categories defined in the International IR Framework for capitals. Comment whether an organisation has to follow these categories rigidly.

2 Can a Not-for Profit organisation do the Integrated Reporting as per the Framework?

3 Can an Integrated reporting be done in compliance to the requirements of the local laws to prepare a management commentary or other reports?

Answers

1. Various categories of capital are:
   - Financial
   - Manufactured
   - Intellectual
   - Human
   - Social and Relationship
   - Natural

   Organizations preparing an integrated report are not required to adopt this categorization or to structure their report along the above lines of the capitals.

2. The Framework is written primarily in the context of private sector, for-profit companies of any size but it can also be applied, adapted as necessary, by public sector and not-for-profit organizations.

3. An integrated report may be prepared in response to existing compliance requirements. For example, an organization may be required by local law to prepare a management commentary or other report that provides context for its financial statements. If that report is also prepared in accordance with this Framework, it can be considered an integrated report. If the report is required to include specified information beyond that required by this Framework, the report can still be considered an integrated report if that other information does not obscure the concise information required by this Framework.

CHAPTER 17

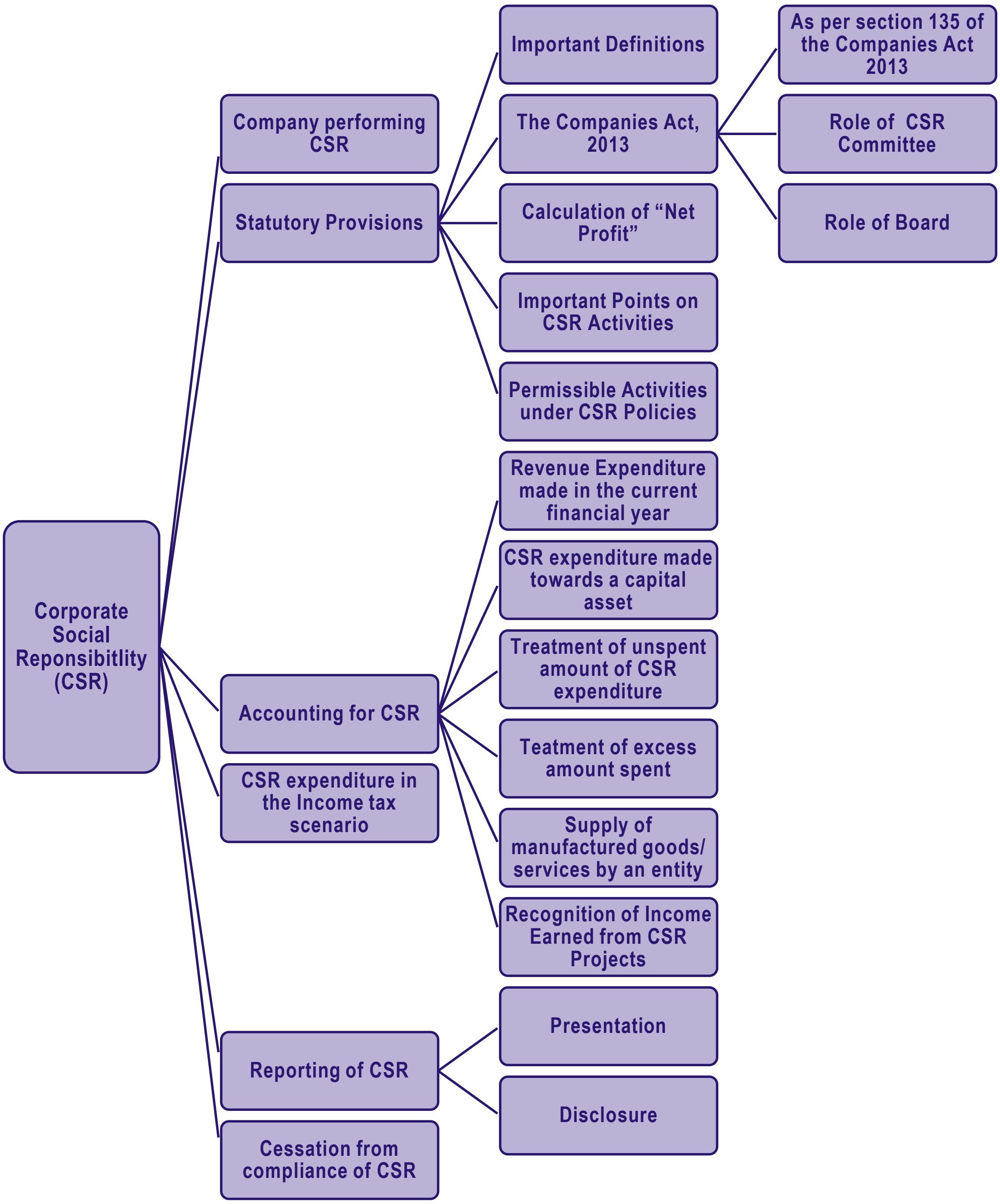
CORPORATE SOCIAL RESPONSIBILITY

LEARNING OUTCOMES

After studying this chapter, you would be able to

- Comprehend corporate social responsibility (CSR).
- Examine the various terminologies used in applying the provisions of CSR
- Analyse the various situations under which CSR shall be implemented as per the statute.
- Deal with the Accounting and Reporting aspects of CSR

CHAPTER OVERVIEW



1. INTRODUCTION

Corporate Social Responsibility ('CSR') is corporate initiative to assess and take responsibility for the company's effects on the environment and its impact on social welfare. It can be conceptualized as the corporations' obligation to take necessary action to reduce the negative externalities and enhance the positive externalities associated with their business. In doing so, the corporations could protect and promote the interests of their stakeholders and society as a whole.

The origin of CSR can be traced to philanthropic activities of corporations, viz., donations and charity. Over the years, the concept of CSR has evolved and it now includes within its scope, triple bottom line approach (achieving a balance of economic, environmental and social imperatives), corporate sustainability, improving and developing skills for sustainability, to name a few.

CSR is the process by which an organization thinks about and evolves its relationships with stakeholders for the common good, and demonstrates its commitment in this regard by adoption of appropriate business processes and strategies. Thus, CSR is not charity or mere donations. CSR is a way of conducting business, by which corporate entities visibly contribute to the social good.

Socially responsible companies do not limit themselves to using resources to engage in activities that increase only their profits. They use CSR to integrate economic, environmental and social objectives with the company's operations and growth.

2. CORPORATE SOCIAL RESPONSIBILITY (CSR)

"Corporate Social Responsibility (CSR)" means and includes but is not limited to:

(1) Projects or programs relating to activities specified in Schedule VII or

(2) Projects or programs relating to activities undertaken by the board of directors of a company (Board) in pursuance of recommendations of the CSR Committee of the Board as per declared CSR Policy of the company

3. WHICH COMPANY TO PERFORM CORPORATE SOCIAL RESPONSIBILITY?

Every company including its holding or subsidiary, and a foreign company defined under clause (42) of section 2 of the Act having its branch office or project office in India which fulfils the criteria specified in sub-section (I) of section 135 of the Act shall comply with the provisions of section 135 of the Act and these rules:

Provided that net worth, turnover or net profit of a foreign company of the Act shall be computed in accordance with balance sheet and profit and loss account of such company prepared in accordance with the provisions of clause (a) of sub-section (1) of section 381 and section 198 of the Act.

Illustration 1

ABC Ltd. is a company which is formed with charitable objects under Section 8 of the Companies Act, 2013. As a result, the management of the company believes that as all the activities of the company will be with the intent of charity, the CSR provisions are not applicable to ABC Ltd. as these activities are activities in normal course of business.

Whether the provisions of CSR are applicable to ABC Ltd. provided it fulfils the criteria of Section 135 of the Act?

Solution

Section 135 of the Companies Act is applicable to every company meeting the specified criteria. As per section 2(20) of the Companies Act, 'company' means a company incorporated under the Companies Act or under any other previous company law. This would imply that companies set up for the purposes of CSR/public welfare are also required to comply with the provisions of CSR.

*****

4. STATUTORY PROVISIONS

In India, the Companies Act, 2013 has statutorily recognised the concept of CSR. Section 135 of the Companies Act, 2013 read with Schedule VII thereto and Companies (Corporate Social Responsibility Policy) Rules, 2014 are the special provisions under the new company law regime imposing mandatory CSR obligations.

4.1 Important Definitions

(a) **Average Net Profit:** "Average Net Profit" is the amount as calculated in accordance with the provisions of Section 198 of the Companies Act, 2013.

(b) **Financial Year:** "Financial Year", in relation to any company or body corporate, means the period ending on the 31st day of March every year, and where it has been incorporated on or after the 1st day of January of a year, the period ending on the 31st day of March of the following year, in respect whereof financial statement of the company or body corporate is made up.

If a holding company or a subsidiary of a company incorporated outside India follows a different financial year for consolidation of its accounts outside India, the Tribunal may allow (on application) any period as its financial year, whether or not that period is a year, provided it align its financial year as per the Act, within a period of two years.

(c) **Net Profit:** "Net Profit" means the net profit of a company as per its financial statement prepared in accordance with the applicable provisions of the Act, but shall not include the following, namely:

(i) any profit arising from any overseas branch or branches of the company, whether operated as a separate company or otherwise; and

(ii) any dividend received from other companies in India, which are covered under and complying with the provisions of section 135 of the Act:

(d) **Net worth:** "Net worth" means the aggregate value of the paid-up share capital and all reserves created out of the profits and securities premium account, after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the audited balance sheet, but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation.

(e) **Turnover:** "Turnover" means the gross amount of revenue recognised in the profit and loss account from the sale, supply, or distribution of goods or on account of services rendered, or both, by a company during a financial year;

(f) **Spend:** The term 'spend' in accounting parlance generally means the liabilities incurred during the relevant accounting period.

4.2 The Companies Act, 2013

A. As per section 135 of the Companies Act 2013

Every company having either

- net worth of ₹ 500 crore or more, or
- turnover of ₹ 1,000 crore or more or
- a net profit of ₹ 5 crore or more

during the immediate preceding financial year

shall constitute a Corporate Social Responsibility (CSR) Committee of the Board consisting of three or more directors (including at least one independent director). However, if a company is not required to appoint an independent director under section 149(4) of the Companies Act, then its CSR Committee shall be formed with 2 or more directors.

Illustration 2

ABC Ltd. is a company which has a net worth of INR 200 crore, it manufactures rubber parts for automobiles. The sales of the company are affected due to low demand of its products.

Required financial details of the following financial years are as follows (INR in crore)

	March 31, 20X4 (Current year) projected	**March 31, 20X3**	**March 31, 20X2**	**March 31, 20X1**
Net Profit	*3.00*	*8.50*	*4.00*	*3.00*
Sales (turnover)	*850*	*950*	*900*	*800*

Does ABC Ltd. has an obligation to form a CSR committee since the applicability criteria is not satisfied in the current financial year?

Solution

A company which meets the net worth, turnover or net profits criteria in immediate preceding financial year will need to constitute a CSR Committee and comply with provisions of sections 135(2) to (5) read with the CSR Rules.

As per the criteria to constitute CSR committee -

1) Net worth greater than or equal to INR 500 Crore: This criterion is not satisfied.
2) Sales greater than or equal to INR 1000 Crore: This criterion is not satisfied.
3) Net profit greater than or equal to INR 5 crore: This criterion is satisfied in financial year ended March 31, 20X3 ie immediate preceding financial year.

Hence, the Company will be required to form a CSR committee.

*****

B. Role of Corporate Social Responsibility (CSR) Committee

The CSR Committee shall—

(a) formulate and recommend to Board-

a. a CSR Policy indicating the activities to be undertaken by the company in the areas or subject specified in Schedule VII;

b. the amount of expenditure to be incurred on the above activities and

(b) monitor the CSR Policy of the company from time to time.

C. Role of Board

Board shall disclose-

(a) The composition of CSR Committee in its report

(b) Approve the recommended CSR Policy for the company

(c) Disclose the contents of such Policy in its report and place it on the company's website

(d) Ensure that the activities included in CSR Policy of the company are duly executed by the company

(e) Ensure that the **company spends, in every financial year, at least two per cent** of the **average net profits** of the company made **during the three immediately preceding financial years** [or where the company has not completed the period of three financial years since its incorporation, during such immediately preceding financial years], by giving preference to the local area and areas around it where it operates

(f) In case the company fails to spend such amount, the Board shall specify the reasons for not spending the amount ***[and unless the unspent amount relates to any ongoing project, transfer such unspent amount to a Fund specified in Schedule VII, within a period of six months of the expiry of the financial year]***

(g) Any amount remaining unspent, pursuant to any ongoing project, undertaken by a company in pursuance of its Corporate Social Responsibility Policy, shall be transferred by the company within thirty days from the end of the financial year to a special account (opened by the company in that behalf for that financial year in any scheduled bank) to be called the Unspent Corporate Social Responsibility Account.

Such amount shall be spent by the company in pursuance of its obligation towards the Corporate Social Responsibility Policy within three financial years from the date of such transfer, failing which, the company shall transfer the same to a Fund specified in Schedule VII, within thirty days from the date of completion of the third financial year.

(h) If a company contravenes the above provisions, the company shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to twenty-five lakh rupees and every defaulting officer of such company shall be punishable with imprisonment for a term upto three years or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees, or with both.

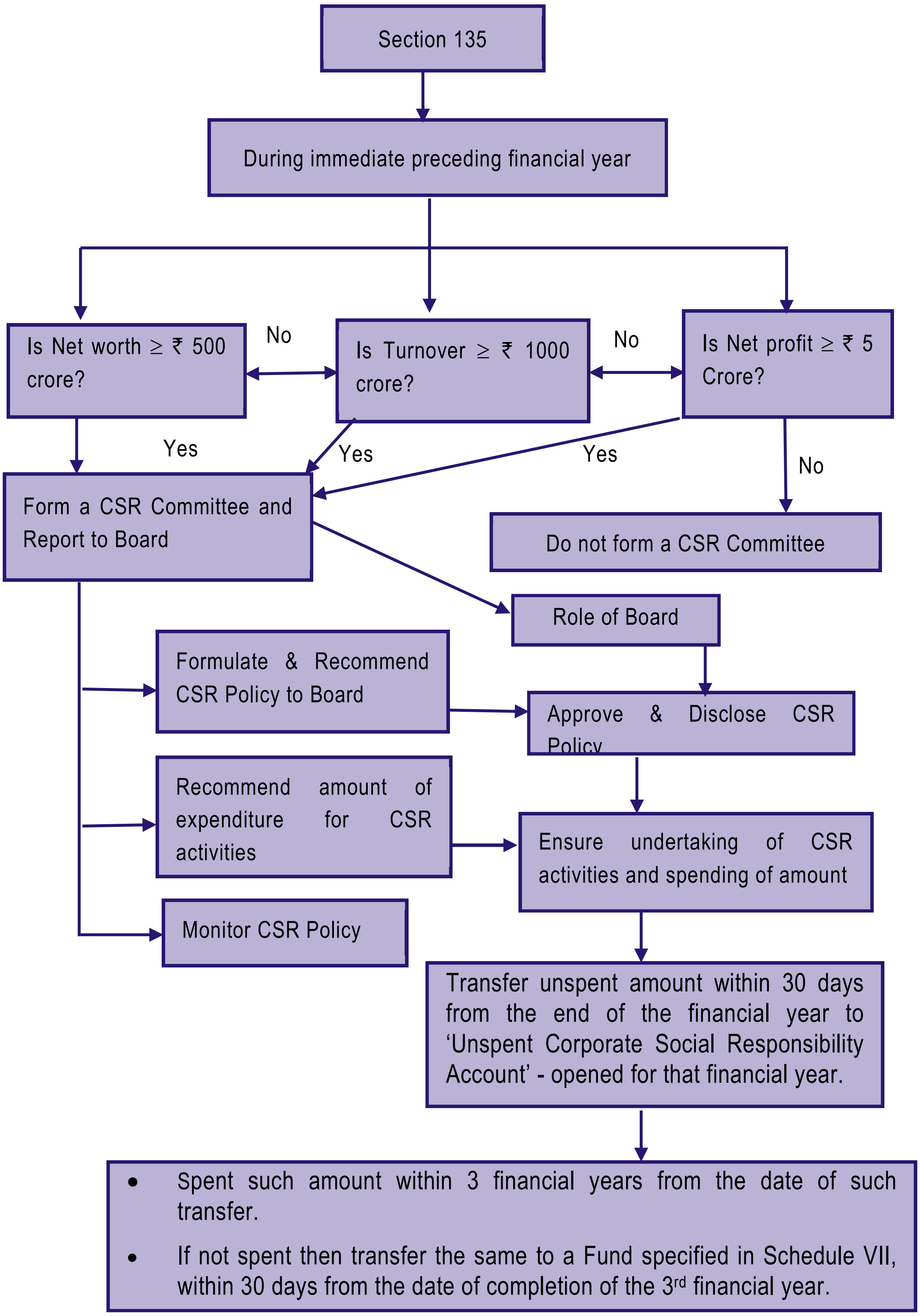

Section 135
During immediate preceding financial year
Is Net worth ≥ ₹ 500 crore?
No
Is Turnover ≥ ₹ 1000 crore?
No
Is Net profit ≥ ₹ 5 Crore?
Yes
Yes
Yes
No
Form a CSR Committee and Report to Board
Do not form a CSR Committee
Role of Board
Formulate & Recommend CSR Policy to Board
Approve & Disclose CSR Policy
Recommend amount of expenditure for CSR activities
Ensure undertaking of CSR activities and spending of amount
Monitor CSR Policy
Transfer unspent amount within 30 days from the end of the financial year to 'Unspent Corporate Social Responsibility Account' - opened for that financial year.
• Spent such amount within 3 financial years from the date of such transfer.
• If not spent then transfer the same to a Fund specified in Schedule VII, within 30 days from the date of completion of the 3rd financial year.

Illustration 3

ABC Ltd. manufactures consumable goods like bath soap, tooth brushes, soap cases etc. As part of its CSR policy, it has decided that for every pack of these goods sold, INR 0.80 will go towards the 'Save Trees Foundation' which will qualify as a CSR spend as per Schedule VII. Consequently, at the year end, the company sold 25,000 such packs and a total of INR 20,000 was recognised as CSR expenditure. However, this amount was not paid to the Foundation at the end of the financial year.

Will the amount of INR 20,000 qualify to be a CSR expenditure?

Solution

By earmarking the amount from such sale for CSR expenditure, the company cannot show it as CSR expenditure. To qualify the amount to be CSR expenditure, it has to be spent. Hence, INR 20,000 will not be automatically considered as CSR expenditure until and unless it is spent on CSR activities.

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4.3 Calculation of "Net Profit" as per Section 198

(1) In computing the net profits of a company in any financial year,

(a) credit shall be given for the sums specified in sub-section (2), and credit shall not be given for those specified in sub-section (3); and

(b) the sums specified in sub-section (4) shall be deducted, and those specified in sub-section (5) shall not be deducted.

(2) In making the computation aforesaid, credit shall be given for the bounties and subsidies received from any Government, or any public authority constituted or authorised in this behalf, by any Government, unless and except in so far as the Central Government otherwise directs.

(3) In making the computation aforesaid, credit shall not be given for the following sums, namely:

(a) profits, by way of premium on shares or debentures of the company, which are issued or sold by the company [unless the company is an investment company];

(b) profits on sales by the company of forfeited shares;

(c) profits of a capital nature including profits from the sale of the undertaking or any of the undertakings of the company or of any part thereof;

(d) profits from the sale of any immovable property or fixed assets of a capital nature comprised in the undertaking or any of the undertakings of the company, unless the business of the company consists, whether wholly or partly, of buying and selling any such property or assets:

Provided that where the amount for which any fixed asset is sold exceeds the written-down value thereof, credit shall be given for so much of the excess as is not higher than the difference between the original cost of that fixed asset and its written down value;

(e) any change in carrying amount of an asset or of a liability recognised in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value;

(f) any amount representing unrealised gains, notional gains or revaluation of assets.

(4) In making the computation aforesaid, the following sums shall be deducted, namely:

(a) all the usual working charges;

(b) directors' remuneration;

(c) bonus or commission paid or payable to any member of the company's staff, or to any engineer, technician or person employed or engaged by the company, whether on a whole-time or on a part-time basis;

(d) any tax notified by the Central Government as being in the nature of a tax on excess or abnormal profits;

(e) any tax on business profits imposed for special reasons or in special circumstances and notified by the Central Government in this behalf;

(f) interest on debentures issued by the company;

(g) interest on mortgages executed by the company and on loans and advances secured by a charge on its fixed or floating assets;

(h) interest on unsecured loans and advances;

(i) expenses on repairs, whether to immovable or to movable property, provided the repairs are not of a capital nature;

(j) outgoings inclusive of contributions made under section 181;

(k) depreciation to the extent specified in section 123;

(l) the excess of expenditure over income, which had arisen in computing the net profits in accordance with this section in any year, in so far as such excess has not been deducted in any subsequent year preceding the year in respect of which the net profits have to be ascertained;

(m) any compensation or damages to be paid in virtue of any legal liability including a liability arising from a breach of contract;

(n) any sum paid by way of insurance against the risk of meeting any liability such as is referred to in clause (m);

(o) debts considered bad and written off or adjusted during the year of account.

(5) In making the computation aforesaid, the following sums shall not be deducted, namely:

(a) income-tax and super-tax payable by the company under the Income-tax Act, 1961, or any other tax on the income of the company not falling under clauses (d) and (e) of sub-section (4);

(b) any compensation, damages or payments made voluntarily, that is to say, otherwise than in virtue of a liability such as is referred to in clause (m) of sub-section (4);

(c) loss of a capital nature including loss on sale of the undertaking or any of the undertakings of the company or of any part thereof not including any excess of the written-down value of any asset which is sold, discarded, demolished or destroyed over its sale proceeds or its scrap value;

(d) any change in carrying amount of an asset or of a liability recognised in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value.

4.4 Important Points on CSR Activities

1. The CSR activities undertaken by the company shall exclude activities undertaken in pursuance of its normal course of business.
2. A company may collaborate with other companies for undertaking projects or programs or CSR activities in such a manner that the CSR committees of respective companies are in a position to report separately on such projects or programs in accordance with these rules.

Illustration 4

How can companies with small CSR funds take up CSR activities in a project/ program mode?

Solution

It has been clarified that companies can combine their CSR programs with other similar companies by pooling their CSR resources.

As per Rule 4 of the CSR Rules, a company may collaborate with other companies for undertaking projects or for CSR activities in such a manner that the CSR committees of the relevant companies are in a position to report separately on such projects in accordance with the prescribed Rules.

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3. The CSR projects or programs or activities undertaken in India only shall amount to CSR expenditure.

Illustration 5

Due to immense loss to Nepal in the recent earthquake, one FMCG Company undertakes various commercial activities with considerable discounts and concessions at the related affected areas of Nepal for a continuous period of 3 months after earthquake. In the Financial Statements for the year 20X1-X2, the Management has shown the expenditure incurred on such activity as expenditure incurred to discharge Corporate Social Responsibility.

State whether the treatment done by the management of management is correct. Explain with reasons.

Solution

The Companies Act, 2013 mandated the corporate entities that the expenditure incurred for Corporate Social Responsibility (CSR) should not be the expenditure incurred for the activities in the ordinary course of business. If expenditure incurred is for the activities in the ordinary course of business, then it will not be qualified as expenditure incurred on CSR activities.

The statutory guidelines relating to CSR also require the deployment of funds for the benefit of the local area of the Company. Since Nepal is another country the expenditure done there i.e. in Nepal shall not qualify to be accounted as CSR expenditure.

Further, it is presumed that the commercial activities performed at concessional rates are the activities done in the ordinary course of business of the company. Therefore, the treatment done by the Management by showing the expenditure incurred on such commercial activities in its financial statements as the expenditure incurred on activities undertaken to discharge CSR, is not correct.

*****

4. The CSR projects or programs or activities that benefit only the employees of the company and their Families shall not be considered as CSR activities in accordance with section 135 of the Act.
5. Companies may build CSR capacities of their own personnel as well as those of their Implementing agencies through Institutions with established track records of at least three financial years but such expenditure (including expenditure on administrative overheads) shall not exceed five percent of total CSR expenditure of the company in one financial year.
6. Contribution of any amount directly or indirectly to any political party, shall not be considered as CSR activity.
7. The surplus arising out of the CSR projects or programs or activities shall not form part of the business profit of a company.

8. CSR expenditure shall include all expenditure including contribution to corpus, for projects or programs relating to CSR activities approved by the Board on the recommendation of its CSR Committee, but does not include any expenditure on an item not in conformity or not in line with activities which fall within the purview of Schedule VII of the Act.

9. The Board's Report of a company shall include an annual report on CSR containing particulars as specified.

Illustration 6

ABC Ltd. is a company which comes under the ambit of Section 135 and CSR Rules. The Board of ABC Ltd did not appropriate the CSR funds and as a result there was no annual report on CSR in the Board's report for financial year ended March 31, 20X1.

Is this a non-compliance as per the Act?

Solution

It has been clarified that as per Rule 9 of the CSR Rules, the Board's Report of a company qualifying under section 135 shall include an annual report on CSR, containing particulars specified in Annexure to CSR Rules. Reporting of CSR policy of the company in the Board's Report is a mandatory requirement. If the disclosure requirements are not fulfilled, penal consequences may be attracted under section 134(8) of the Companies Act.

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4.5 Permissible Activities under Corporate Social Responsibility Policies: Schedule VII

As per Schedule VII of Companies Act 2013, following activities may be included by companies in their Corporate Social Responsibility Policies Activities relating to:

1. eradicating hunger, poverty and malnutrition, promoting health care including preventive health care and sanitation including contribution to the Swach Bharat Kosh set-up by the Central Government for the promotion of sanitation and making available safe drinking water.

2. promoting education, including special education and employment enhancing vocation skills especially among children, women, elderly and the differently abled and livelihood enhancement projects.

3. promoting gender equality, empowering women, setting up homes and hostels for women and orphans; setting up old age homes, day care centres and such other facilities for senior citizens and measures for reducing inequalities faced by socially and economically backward groups;

4. ensuring environmental sustainability, ecological balance, protection of flora and fauna, animal welfare, agroforestry, conservation of natural resources and maintaining quality of soil, air and water including contribution to the Clean Ganga Fund set-up by the Central Government for rejuvenation of river Ganga;

5. protection of national heritage, art and culture including restoration of buildings and sites of historical importance and works of art; setting up public libraries; promotion and development of traditional arts and handicrafts;
6. measures for the benefit of armed forces veteran, war widows and their dependents;
7. training to promote rural sports nationally recognized sports and Olympic sports;
8. contribution to the Prime Minister's National Relief Fund or any other fund set up by the Central Government for socio-economic development and relief and welfare of the Scheduled Castes, the Scheduled Tribes, other backward classes, minorities and women; and
9. contributions or funds provided to technology incubators located within academic institutions which are approved by the Central Government;
10. rural development projects.
11. slum area development.
12. ***disaster management, including relief, rehabilitation and reconstruction activities.***

5. ACCOUNTING FOR CSR TRANSACTIONS

5.1 Revenue Expenditure made in the Current Financial Year

	Debit (INR)	Credit(INR)
CSR Expenditure (Profit and loss statement)	XXX	
To Cash/Vendor		XXX

CSR Expenditure is an item of profit and loss statement.

Item 5 (A)(k) of the General Instructions for Preparation of Statement of Profit and Loss under Schedule III to the Companies Act, 2013, requires that in case of companies covered under Section 135, the amount of expenditure incurred on ‘Corporate Social Responsibility Activities’ shall be disclosed by way of a note to the statement of profit and loss.

The treatment of revenue expenditure will be the same under AS and Ind AS.

5.2 CSR Expenditure made towards a Capital Asset

In case the expenditure incurred by the company is of such a nature that give rise to an ‘asset’, it should be recognised by the company in its balance sheet, provided the control over the asset is with the Company and future economic benefits are expected to flow to the company.

Example

A school building is transferred to a Gram Panchayat for running and maintaining the school, it should not be recognised as 'an asset' in its books and such expenditure would need to be charged to the statement of profit and loss as and when incurred.

1. Accounting treatment as per AS

Where any CSR asset is recognized in its balance sheet, the same may be classified under natural head (e.g. Tangible assets or Intangible assets) with specific subhead of 'CSR Asset' if the expenditure satisfies the recognition criteria of 'asset'.

	Debit (INR)	Credit(INR)
CSR Asset (Balance Sheet)	XXX	
To Cash/Vendor		XXX

2. Accounting treatment as per Ind AS

The accounting entry as given above remains the same. However, there is a difference in the classification of Non-current asset under Ind AS.

Where any CSR asset is recognized in its balance sheet, the same may be classified under natural head (e.g. Property plant and equipment, Intangible assets or Investment property) with specific sub-head of 'CSR Asset' if the expenditure satisfies the recognition criteria of 'asset'.

The recognition criteria for asset under Ind AS i.e.,

- Ind AS 16 : Property, plant and equipment,
- Ind AS 40 : Investment Property
- Ind AS 38 : Intangible assets

is to be satisfied.

Illustration 7

A building is used for CSR activities of the company. The same is capitalised as 'an asset' in the books and depreciation is charged on the same as per the Companies Act, 2013. The Company claims the cost of the building as 'CSR expenditure' and also the depreciation thereon.

Is this the correct treatment as per the Act?

Solution

In case the expenditure incurred by the company is of such nature which may give rise to an 'Asset', it should be recognised by the company in its balance sheet, provided the control over the asset is with the Company and future economic benefits are expected to flow to the company. Where any CSR asset is recognized in its balance sheet, the same may be classified under natural head (e.g. Building, Plant & Machinery etc.) with specific sub-head of 'CSR Asset' if the expenditure satisfies the definition of 'asset'.

For example, a building used for CSR activities where the beneficial interest has not been relinquished for lifetime by a company and from which any economic benefits flow to a company, may be recognised as 'CSR Building' for the purpose of reflecting the same in the balance sheet.

If an amount spent on an asset has been shown as CSR spend, then the depreciation on such asset cannot be claimed as CSR spend again. Once cost of the asset is included for CSR spend, then the depreciation on such asset will not be included for CSR spend even if the asset is capitalized in the books of accounts and depreciation charged thereon.

*****

5.3 Whether any Unspent Amount of CSR Expenditure is to be Provided for?

- **Section 135 (5) of the Companies Act, 2013**, requires that the Board of every eligible company, "shall ensure that the company spends, in every financial year, at least 2% of the average net profits of the company made during the three immediately preceding financial ***years or where the company has not completed the period of three financial years since its incorporation, during such immediately preceding financial years,*** in pursuance of its Corporate Social Responsibility Policy". A proviso to this Section states that "if the company fails to spend such amount, the Board shall, in its report specify the reasons for not spending the amount ***and, unless the unspent amount relates to any ongoing project, transfer such unspent amount to a Fund specified in Schedule VII, within a period of six months of the expiry of the financial year".***

- ***Any amount remaining unspent, pursuant to any ongoing project, undertaken by a company in pursuance of its Corporate Social Responsibility Policy, shall be transferred by the company within a period of thirty days from the end of the financial year to a special account to be opened by the company in that behalf for that financial year in any scheduled bank to be called the Unspent Corporate Social Responsibility Account. uch amount shall be spent by the company in pursuance of its obligation towards the Corporate Social Responsibility Policy within a period of three financial years from the date of such transfer, failing which, the company shall transfer the same to a Fund specified in Schedule VII, within a period of thirty days from the date of completion of the third financial year.***

- ***If a company contravenes the provisions, the company shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to twenty-five lakh rupees and every officer of such company who is in default shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees, or with both.***

5.4 Whether the Excess Amount can be Carry Forward to set off against Future CSR Expenditure?

Where a company spends more than that required under law, a question arises as to whether the excess amount 'spent' can be carried forward to be adjusted against amounts to be spent on CSR activities in future period.

As per Section 135 (5) of the Companies Act, the Board shall ensure that the company spends, in every financial year, **at least two per cent of the average net profits** of the company made during the three immediately preceding financial years ***or where the company has not completed the period of three financial years since its incorporation, during such immediately preceding financial years,*** in pursuance of its Corporate Social Responsibility Policy.

Since 2% of average net profits of immediately preceding three years is the minimum amount which is required to be spent under section 135(5) of the Act, the excess amount cannot be carried forward for set off against the CSR expenditure required to be spent in future.

Accounting treatment as per AS and Ind AS

It has been clarified that the Board is free to decide whether any unspent amount is to be carried forward to the next year, and the same shall be over and above the next year's CSR allocation equivalent to at least 2% of average net profits of the company. Any shortfall in spending in CSR shall be explained in the directors' report and the Board of Directors shall state the amount unspent and reasons for not spending that amount. Any shortfall is now required as per law to be provided for in the books of accounts if the CSR project is ongoing. In other words, if a company has already undertaken certain CSR activity for which an obligation has been created, for example, by entering into a contractual obligation, or either a constructive obligation has arisen during the year, then a provision for the amount of such CSR obligation, should be recognised in the financial statements.

Illustration 8

ABC Ltd. is a company which is covered under the ambit of CSR rules. As part of its CSR contribution an amount of ₹ 15,00,000 was spent as CSR expense towards the education of girl child. The average net profit of the company for the past three years was ₹ 70,00,000. As the company incurred a CSR expense in excess of what is required by the rules, it decided to utilise this expense as a carry forward to the next year and reduce next year's CSR spend by ₹ 1,00,000.

Can the excess expenditure towards CSR be carried forward to next financial year?

Solution

There is no provision for carrying forward the excess CSR expenditure spent in a particular year. Any expenditure over 2% could be considered as voluntary higher CSR spend for that year.

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5.5 Supply of Manufactured Goods/ Services by an Entity

In some cases, a company may supply goods manufactured by it or render services as CSR activities. In such cases, the expenditure incurred should be recognised when the control on the goods manufactured by it is transferred or the allowable services are rendered by the employees.

- The goods manufactured by the company should be valued in accordance with the principles prescribed in Accounting Standard (AS) 2, Valuation of Inventories.
- The services rendered should be measured at cost. Indirect taxes on the goods and services so contributed will also form part of the CSR expenditure.
- Where a company receives a grant from others for carrying out CSR activities, the CSR expenditure should be measured net of the grant.

Illustration 9

After the havoc caused by flood in Jammu and Kashmir, a group of companies undertakes during the period from October, 20X1 to December, 20X1 various commercial activities, with considerable concessions/discounts, along the related affected areas. The management intends to highlight the expenditure incurred on such activities as expenditure incurred on activities undertaken to discharge corporate social responsibility, while publishing its financial statements for the year 20X1-20X2.

State whether the management's intention is correct or not and why?

Solution

Corporate Social Responsibility (CSR) Reporting is an information communiqué with respect to discharge of social responsibilities of corporate entity. Through 'CSR Report' the corporate enterprises disclose the manner in which they are discharging their social responsibilities. More specifically, it is addressed to the public or society at large, although it can be squarely used by other user groups also.

Section 135 of the Companies Act, 2013 mandated the companies fulfilling the criteria mentioned in the said section to spend certain amount of their profit on activities as specified in the Schedule VII to the Act. Companies not falling within that criteria can also spend on CSR activities voluntarily. However, besides the requirements of constitution of a CSR committee and a CSR policy, the corporate entities should also take care that expenditure incurred for CSR should not be the expenditure incurred for the activities in the ordinary course of business. If expenditure incurred is for the activities in the ordinary course of business, then it will not be qualified as expenditure incurred on CSR activities.

Here, it is assumed that the commercial activities performed at concessional rates are the activities done in the ordinary course of business of the companies. Therefore, the intention of the management to highlight the expenditure incurred on such commercial activities in its financial statements as the expenditure incurred on activities undertaken to discharge CSR, is not correct.

*****

5.6 Recognition of Income Earned from CSR Projects/ Programmes or During the Course of Conduct of CSR Activities

Rule 6(2) of the Companies (Corporate Social Responsibility Policy) Rules, 2014, requires that "the surplus arising out of the CSR projects or programs or activities shall not form part of the business profit of a company".

- The term 'surplus' ordinarily means excess of income over expenditure pertaining to an entity or an activity. Thus, in respect of a CSR project or programme or activity, it needs to be determined whether any surplus is arising therefrom.
- A question would arise as to whether such surplus should be recognised in the statement of profit and loss of the company. It may be noted that paragraph 5 of Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, inter alia, requires that all items of income which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise. As to whether the surplus from CSR activities can be considered as 'income', the Framework for Preparation and Presentation of Financial Statements issued by the Institute of Chartered Accountants of India, defines 'income' as "increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants".
- Since the surplus arising from CSR activities is not arising from a transaction with the owners, it would be considered as 'income' for accounting purposes.
- In view of the aforesaid requirement any surplus arising out of CSR project or programme or activities shall be recognised in the statement of profit and loss and since this surplus cannot be a part of business profits of the company, the same should immediately be recognised as liability for CSR expenditure in the balance sheet and recognised as a charge to the statement of profit and loss.
- Accordingly, such surplus would not form part of the minimum '2% of the average net profits of the company made during the three immediately preceding financial years in pursuance of its Corporate Social Responsibility Policy'.

6. CSR EXPENDITURE IN THE INCOME TAX SCENARIO

1. CSR expenditure, being an application of income, is not incurred wholly and exclusively for the purposes of carrying on business. As the application of income is not allowed as deduction for the purposes of computing taxable income of a company, amount spent on CSR cannot be allowed as deduction for computing the taxable income of the company.
2. The CSR expenditure which is of the nature described in section 30 to section 36 of the Income-tax Act shall be allowed as deduction under those sections subject to fulfilment of conditions, if any, specified therein. If the nature of CSR expenditure incurred is not covered under the aforesaid sections of the Act and is covered under section 37(1) of the Act, ie any expenditure incurred by an assessee on the activities relating to corporate social responsibility referred to in section 135 of the Companies Act, 2013 (18 of 2013) shall not be deemed to be an expenditure incurred by the assessee for the purposes of the business or profession.

Illustration 10

ABC Ltd. carries out CSR activities from rented premises in Pune. The rent paid for such premises is disclosed as CSR expenditure and subsequently ABC Ltd. also claimed deduction of the same under the Income-tax Act. Is this permissible?

Solution

CSR expenditure which is of the nature described under the section 30 to 36 of the Income-tax Act shall be allowed as a deduction. Rent expenses can be claimed under section 30 of the Act and hence it can be claimed as a deduction.

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7. REPORTING OF CSR: PRESENTATION AND DISCLOSURE IN THE FINANCIAL STATEMENTS

1. General Instructions for Preparation of Statement of Profit and Loss under Schedule III to the Companies Act, 2013, requires that in case of companies covered under Section 135, the amount of expenditure incurred on 'Corporate Social Responsibility Activities' shall be disclosed by way of a note to the statement of profit and loss.
2. From the perspective of better financial reporting and still be in line with the requirements of Schedule III in this regard, it is recommended that all expenditure on CSR activities, that qualify to be recognised as expense in accordance with the relevant provisions as

discussed above should be recognised as a separate line item as 'CSR expenditure' in the statement of profit and loss.

3. Further, the relevant note should disclose the break-up of various heads of expenses included in the line item 'CSR expenditure'.

4. The notes to accounts relating to CSR expenditure should also contain the following:

   a) Gross amount required to be spent by the company during the year.

   b) Amount spent during the year on:

		In cash	Yet to be paid in cash	Total
(i)	Construction/acquisition of any asset			
(ii)	On purposes other than (i) above			

   The above disclosure, to the extent relevant, may also be made in the notes to the cash flow statement, where applicable.

   c) Details of related party transactions, e.g., contribution to a trust controlled by the company in relation to CSR expenditure as per Accounting Standard (AS) 18, Related Party Disclosures.

   d) Where a provision is made in accordance with paragraph 8 above the same should be presented as per the requirements of Schedule III to the Companies Act, 2013. Further, movements in the provision during the year should be shown separately.

TEST YOUR KNOWLEDGE

Questions

1. A property is being constructed to operate CSR activities by a company. At the balance sheet date, the cost of construction is treated as revenue expenditure. Are there any additional disclosures required in the financials regarding this?

2. In the year 20X1, XYZ Ltd. falls within the purview of CSR provisions as per the Companies Act, 2013 since its net profit for the financial year exceeded ₹ 5 crore. The company discharged CSR obligations in the year 20X2. However, the net profit of the year 20X2 was less than ₹ 5 crores. Also, it was also not satisfying the other two criteria of the section 135 for CSR compliance. Therefore, the company stopped performing CSR activities from the year 20X3 onwards. Comment on the company's accountability for CSR.

Answers

1. General Instructions for Preparation of Statement of Profit and Loss under Schedule III to the Companies Act, 2013, requires that in case of companies covered under Section 135, the amount of expenditure incurred on 'Corporate Social Responsibility Activities' shall be disclosed by way of a note to the statement of profit and loss. The note should also disclose the details with regard to the expenditure incurred in construction of a capital asset under a CSR project.

2. Once a company has fulfilled the net worth / turnover / net profit criterion for one year it has to fulfil its CSR obligations for the subsequent three financial years, even if it does not fulfil any of these criteria in those years.

   In the given case XYZ Ltd. falls in the ambit of CSR obligations by fulfilling the criteria of net profit exceeding ₹ 5 crores in the year 20X1. So it has to discharge its CSR obligations by spending two percent of its average profit every year starting from 20X2 till 20X4. It cannot stop spending on CSR activities as per the Act after 20X2.