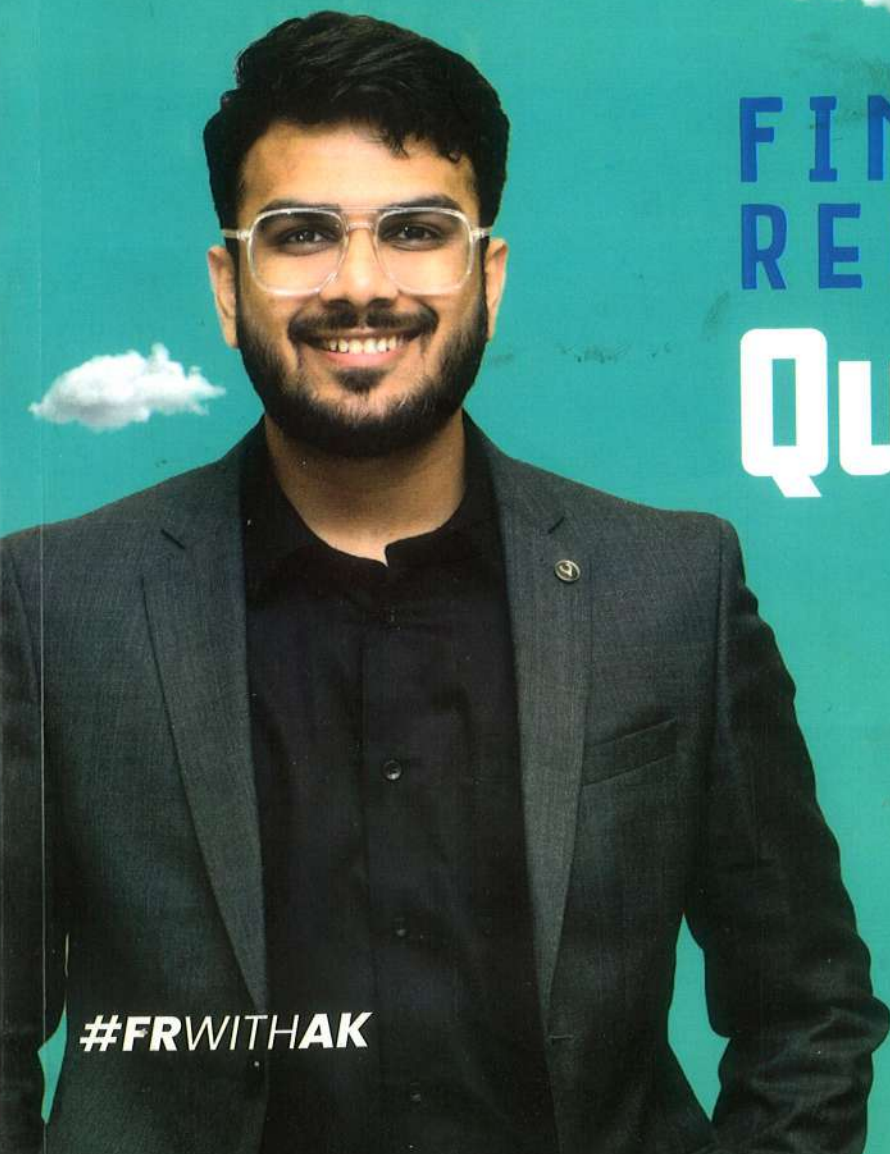




FINANCIAL REPORTING Question Bank

Edition 8

VOLUME-3
BY CA AAKASH KANDOI

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FINANCIAL REPORTING

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ANALYSIS OF FINANCIAL STATEMENTS

Note: Repetitive Case Studies Questions Already Covered In Respective IND AS are not repeated here again.

Case Study 1 – (RTP Nov'20, MTP Nov'21, Nov'23)

Deepak started a new company Softbharti Pvt. Ltd. with Iktara Ltd. wherein investment of 55% is done by Iktara Ltd. and rest by Deepak. Voting powers are to be given as per the proportionate share of capital contribution. The new company formed was the subsidiary of Iktara Ltd. with two directors, and Deepak eventually becomes one of the directors of company. A consultant was hired and he charged ₹ 30,000 for the incorporation of company and to do other necessary statutory registrations. ₹ 30,000 is to be charged as an expense in the books after incorporation of company. The company, Softbharti Pvt. Ltd. was incorporated on 1st April 2019.

The financials of Iktara Ltd. are prepared as per Ind AS.

An accountant who was hired at the time of company's incorporation, has prepared the draft financials of Softbharti Pvt. Ltd. for the year ending 31st March, 2020 as follows:

Statement of Profit and Loss

Particulars	Amount (₹)
Revenue from operations	10,00,000
Other Income	1,00,000
Total Revenue (a)	11,00,000
Expenses:	
Purchase of stock in trade	5,00,000
(Increase)/Decrease in stock in trade	(50,000)
Employee benefits expense	1,75,000
Depreciation	30,000
Other expenses	90,000
Total Expenses (b)	7,45,000
Profit before tax (c) = (a)-(b)	3,55,000
Current tax	1,06,500
Deferred tax	6,000
Total tax expense (d)	1,12,500
Profit for the year (e) = (c) – (d)	2,42,500

Balance Sheet

Particulars	Amount (₹)
EQUITY AND LIABILITIES	
(1) Shareholders' Funds	
(a) Share Capital	1,00,000
(b) Reserves & Surplus	2,27,500
(2) Non-Current Liabilities	
(a) Long Term Provisions	25,000
(b) Deferred tax liabilities	6,000
(3) Current Liabilities	

(a) Trade Payables	11,000
(b) Other Current Liabilities	45,000
(c) Short Term Provisions	<u>1,06,500</u>
TOTAL	<u>5,21,000</u>
ASSETS	
(1) Non Current Assets	
(a) Property, plant and equipment (net)	1,00,000
(b) Long-term Loans and Advances	40,000
(c) Other Non Current Assets	50,000
(2) Current Assets	
(a) Current Investment	30,000
(b) Inventories	80,000
(c) Trade Receivables	55,000
(d) Cash and Bank Balances	1,15,000
(e) Other Current Assets	<u>51,000</u>
TOTAL	<u>5,21,000</u>

Additional information of Softbharti Pvt Ltd.:

- Deferred tax liability of ₹ 6,000 is created due to following temporary difference: Difference in depreciation amount as per Income tax and Accounting profit
- There is only one property, plant and equipment in the company, whose closing balance as at 31st March, 2020 is as follows:

Asset description	As per Books	As per Income tax
Property, plant and equipment	₹ 1,00,000	₹ 80,000

- Pre incorporation expenses are deductible on straight line basis over the period of five years as per Income tax. However, the same are immediately expensed off in the books.
- Current tax is calculated at 30% on PBT - ₹ 3,55,000 without doing any adjustments related to Income tax. The correct current tax after doing necessary adjustments of allowances / disallowances related to Income tax comes to ₹ 1,25,700.
- After the reporting period, the directors have recommended dividend of ₹ 15,000 for the year ending 31st March, 2020 which has been deducted from reserves and surplus. Dividend payable of ₹ 15,000 has been grouped under 'other current liabilities' alongwith other financial liabilities.
- There are 'Government statutory dues' amounting to ₹ 15,000 which are grouped under 'other current liabilities'.
- The capital advances amounting to ₹ 50,000 are grouped under 'Other non-current assets'.
- Other current assets of ₹ 51,000 comprise Interest receivable from trade receivables.
- Current investment of ₹ 30,000 is in shares of a company which was done with the purpose of trading; current investment has been carried at cost in the financial statements. The fair value of current investment in this case is ₹ 50,000 as at 31st March, 2020.

10. Actuarial gain on employee benefit measurements of ₹ 1,000 has been omitted in the financials of Softbharti private limited for the year ending 31 st March, 2020.

The financial statements for financial year 2019-2020 have not been yet approved.

You are required to ascertain that whether the financial statements of Softbharti Pvt. Ltd. are correctly presented as per the applicable financial reporting framework. If not, prepare the revised financial statements of Softbharti Pvt. Ltd. after the careful analysis of mentioned facts and information. **(16 Marks)**

Solution:

If Ind AS is applicable to any company, then Ind AS shall automatically be made applicable to all the subsidiaries, holding companies, associated companies, and joint ventures of that company, irrespective of individual qualification of set of standards on such companies.

In the given case it has been mentioned that the financials of Iktara Ltd. are prepared as per Ind AS. Accordingly, the results of its subsidiary Softbharti Pvt. Ltd. should also have been prepared as per Ind AS. However, the financials of Softbharti Pvt. Ltd. have been presented as per accounting standards (AS).

Hence, it is necessary to revise the financial statements of Softbharti Pvt. Ltd. as per Ind AS after the incorporation of necessary adjustments mentioned in the question.

The revised financial statements of Softbharti Pvt. Ltd. as per Ind AS and Division II to Schedule III of the Companies Act, 2013 are as follows:

STATEMENT OF PROFIT AND LOSS for the year ended 31st March, 2020

Particulars	Amount (₹)
Revenue from operations	10,00,000
Other Income (1,00,000 + 20,000) (refer note -1)	1,20,000
Total Revenue	11,20,000
Expenses:	
Purchase of stock in trade	5,00,000
(Increase) / Decrease in stock in trade	(50,000)
Employee benefits expense	1,75,000
Depreciation	30,000
Other expenses	90,000
Total Expenses	7,45,000
Profit before tax	3,75,000
Current tax	1,25,700
Deferred tax (W.N.1)	4,800
Total tax expense	1,30,500
Profit for the year (A)	2,44,500
OTHER COMPREHENSIVE INCOME	
Items that will not be reclassified to Profit or Loss:	
Remeasurements of net defined benefit plans	1,000
Tax liabilities relating to items that will not be reclassified to Profit or Loss	
Remeasurements of net defined benefit plans (tax) [1000 x 30%]	(300)
Other Comprehensive Income for the period (B)	700
Total Comprehensive Income for the period (A+B)	2,45,200

BALANCE SHEET as at 31st March, 2020

Particulars	(₹)
ASSETS	
Non-current assets	
Property, plant and equipment	1,00,000
Financial assets	
Other financial assets (Long-term loans and advances)	40,000
Other non-current assets (capital advances) (refer note-2)	50,000
Current assets	
Inventories	80,000
Financial assets	
Investments (30,000 + 20,000) (refer note -1)	50,000
Trade receivables	55,000
Cash and cash equivalents/Bank	1,15,000
Other financial assets (Interest receivable from trade receivables)	51,000
TOTAL ASSETS	5,41,000
EQUITY AND LIABILITIES	
Equity	
Equity share capital	1,00,000
Other equity	2,45,200
Non-current liabilities	
Provision (25,000 – 1,000)	24,000
Deferred tax liabilities (4800 + 300)	5,100
Current liabilities	
Financial liabilities	
Trade payables	11,000
Other financial liabilities (Refer note 5)	15,000
Other current liabilities (Govt. statutory dues) (Refer note 3)	15,000
Current tax liabilities	1,25,700
TOTAL EQUITY AND LIABILITIES	5,41,000

STATEMENT OF CHANGES IN EQUITY For the year ended 31st March, 2020

A. EQUITY SHARE CAPITAL

	Balance (₹)
As at 31st March, 2019	-
Changes in equity share capital during the year	<u>1,00,000</u>
As at 31st March, 2020	<u>1,00,000</u>

B. OTHER EQUITY

	Reserves & Surplus
	Retained Earnings (₹)
As at 31st March, 2019	-
Profit for the year	2,44,500
Other comprehensive income for the year	700
Total comprehensive income for the year	2,45,200

Less: Dividend on equity shares (refer note – 4)	=
As at 31st March, 2020	<u>2,45,200</u>

DISCLOSURE FORMING PART OF FINANCIAL STATEMENTS:

Proposed dividend on equity shares is subject to the approval of the shareholders of the company at the annual general meeting and not recognized as liability as at the Balance Sheet date. (refer note-4)

Notes:

1. Current investment are held for the purpose of trading. Hence, it is a financial asset classified as FVTPL. Any gain in its fair value will be recognised through profit or loss. Hence, ₹ 20,000 (50,000 – 30,000) increase in fair value of financial asset will be recognised in profit and loss. However, it will attract deferred tax liability on increased value (Refer W.N).
2. Assets 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.
3. Liabilities for which there is no contractual obligation to deliver cash or other financial asset to another entity, are not financial liabilities.
4. As per Ind AS 10, 'Events after the Reporting Period', If dividends are declared after the reporting period but before the financial statements are approved for issue, the dividends are not recognized 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.
5. Other current financial liabilities:

	(₹)
Balance of other current liabilities as per financial statements	45,000
Less: Dividend declared for FY 2019 - 2020 (Note – 4)	(15,000)
Reclassification of government statutory dues payable to 'other current liabilities'	(15,000)
Closing balance	15,000

Working Note:**Calculation of deferred tax on temporary differences as per Ind AS 12 for financial year 2019 - 2020**

Item	Carrying amount (₹)	Tax base (₹)	Difference (₹)	DTA / DTL @ 30% (₹)
Property, Plant and Equipment	1,00,000	80,000	20,000	6,000-DTL
Pre-incorporation expenses	Nil	24,000	24,000	7,200-DTA
Current Investment	50,000	30,000	20,000	6,000-DTL
Net DTL				<u>4,800-DTL</u>

Case Study 2

Mumbai Challengers Ltd., a listed entity, is a sports organization owning several cricket and hockey teams. The issues below pertain to the reporting period ending 31 March 20X2.

- a) Owing to the proposed schedules of Indian Hockey League as well as Cricket Premier Tournament, Mumbai Challengers Ltd. needs a new stadium to host the sporting events. This stadium will form a part of the Property, Plant and Equipment of the company. Mumbai Challengers Ltd. began the construction of the stadium on 1 December, 20X1. The construction of the stadium was completed in 20X2-20X3. Costs directly related to the construction amounted to ₹ 140 crores in December 20X1. Thereafter, ₹ 350 crores have been incurred per month until the end of the financial year. The

company has not taken any specific borrowings to finance the construction of the stadium, although it has incurred finance costs on its regular overdraft during the period, which were avoidable had the stadium not been constructed. Mumbai Challengers Ltd. has calculated that the weighted average cost of the borrowings for the period 1 December 20X1 to 31 March 20X2 amounted to 15% per annum on an annualized basis.

The company seeks advice on the treatment of borrowing costs in its financial statements for the year ending 31 March 20X2.

- b) Mumbai Challengers Ltd. acquires and sells players' registrations on a regular basis. For a player to play for its team, Mumbai Challengers Ltd. must purchase registrations for that player. These player registrations are contractual obligations between the player and the company. The costs of acquiring player registrations include transfer fees, league levy fees, and player agents' fees incurred by the club.

At the end of each season, which happens to also be the reporting period end for Mumbai Challengers Ltd., the club reviews its contracts with the players and makes decisions as to whether they wish to sell/transfer any players' registrations. The company actively markets these registrations by circulating with other clubs a list of players' registrations and their estimated selling price. Players' registrations are also sold during the season, often with performance conditions attached. In some cases, it becomes clear that a player will not play for the club again because of, for example, a player sustaining a career threatening injury or being permanently removed from the playing squad for any other reason. The playing registrations of certain players were sold after the year end, for total proceeds, net of associated costs, of ₹ 175 crores. These registrations had a net book value of ₹ 49 crores.

Mumbai Challengers Ltd. seeks your advice on the treatment of the acquisition, extension, review and sale of players' registrations in the circumstances outlined above.

- c) Mumbai Challengers Ltd. measures its stadiums in accordance with the revaluation model. An airline company has approached the directors offering ₹ 700 crores for the property naming rights of all the stadiums for five years. Three directors are on the management boards of both Mumbai Challengers Ltd. and the airline. Additionally, statutory legislations regulate the financing of both the cricket and hockey clubs. These regulations prevent contributions to the capital from a related party which 'increases equity without repayment in return'. Failure to adhere to these legislations could lead to imposition of fines and withholding of prize money.

Mumbai Challengers Ltd. wants to know how to take account of the naming rights in the valuations of the stadium and the potential implications of the financial regulations imposed by the legislations.

Solution

a) Borrowing Costs

As per Ind AS 23 Borrowing Costs, an entity shall capitalize borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset (i.e. an asset that necessarily takes a substantial period of time to get ready for its intended use or sale) as part of the cost of that asset. 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. 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 capitalization by applying a capitalization rate to the expenditures on that asset. The capitalization rate shall be the weighted average of the borrowing costs applicable to all borrowings of the entity that are outstanding during the period.

The capitalization rate of the borrowings of Mumbai Challengers Ltd. during the period of construction is 15% per annum (as given in the question), and therefore, the total amount of borrowing costs to be capitalized is the expenditures incurred on the asset multiplied by the capitalization rate, which is as under:

Particulars	₹ in crores
Costs incurred in December 20X1: (₹ 140 crores x 15% x 4/12)	7.000

Costs incurred in January 20X2: (₹ 350 crores x 15% x 3/12)	13.125
Costs incurred in February 20X2: (₹ 350 crores x 15% x 2/12)	8.750
Costs incurred in March 20X2: (₹ 350 crores x 15% x 1/12)	4.375
Borrowing Costs to be capitalized in 20X1-X2	33.250

OR

Weighted average carrying amount of the stadium during 20X1-X2 is:

₹ (140 + 490 + 840 + 1,190) crores/4 = ₹ 665 crores

Applying the weighted average rate of borrowings of 15% per annum, the borrowing cost to be capitalized is computed as:

₹ 665 crores x (15% x 4/12) = ₹ 33.25 crores

b) Players' Registrations

Acquisition

As per Ind AS 38 Intangible Assets, an entity should recognize an intangible asset where it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity and the cost of the asset can be measured reliably. Accordingly, the costs associated with the acquisition of players' registrations would need to be **capitalized which would be the amount of cash or cash equivalent paid or the fair value of other consideration given to acquire such registrations**. In line with Ind AS 38 Intangible Assets, costs would include transfer fees, league levy fees, and player agents' fees incurred by the club, along with other directly attributable costs, if any. Amounts capitalized would be fully amortized over the period covered by the player's contract.

Sale of registrations

Player registrations would be classified as assets held for sale under Ind AS 105 Non- Current Assets Held for Sale and Discontinued Operations when their carrying amount is expected to be recovered principally through a sale transaction and a sale is considered to be highly probable. To consider a sale to be 'highly probable', the assets (in this case, player registrations) should be actively marketed for sale at a price that is reasonable in relation to its current fair value. In the given case, it would appear that the management is committed to a plan to sell the registration, that the asset is available for immediate sale and that an active plan to locate a buyer is already in place by circulating clubs. Ind AS 105 stipulates that it should be unlikely that the plan to sell the registrations would be significantly changed or withdrawn. To fulfil this requirement, it would be prudent if only those registrations are classified as held for sale where unconditional offers have been received prior to the reporting date.

Once the conditions for classifying assets as held for sale in accordance with Ind AS 105 have been fulfilled, the player registrations would be stated at lower of carrying amount and fair value less costs to sell, with the carrying amount stated in accordance with Ind AS 38 prior to application of Ind AS 105, subjected to impairment, if any.

Profits and losses on sale of players' registrations would be computed by deducting the carrying amount of the players' registrations from the fair value of the consideration receivable, net of transactions costs. In case a portion of the consideration is receivable on the occurrence of a future performance condition (i.e. contingent consideration), this amount would be recognized in the Statement of Profit and Loss only when the conditions are met.

The players registrations disposed of, subsequent to the year end, for ₹ 175 crores, having a corresponding book value of ₹ 49 crores would be disclosed as a non-adjusting event in accordance with Ind AS 10 Events after the Reporting Period.

Impairment review

Ind AS 36 Impairment of Assets requires companies to **annually test their assets for impairment**. An asset is said to be impaired if the carrying amount of the asset exceeds its recoverable amount. The recoverable amount is higher of the asset's fair value less costs to sell and its value in use (which is the present value of future cash flows expected to arise from the use of the asset). In the given scenario, it is

not easy to determine the value in use of any player in isolation as that player cannot generate cash flows on his/her own unless via a sale transaction or an insurance recovery. Whilst any individual player cannot really be separated from the single cash-generating unit (CGU), being a cricket team or a hockey team in the instant case, there may be certain instances where a player is taken out of the CGU when it becomes clear that he/she will not play for the club again. If such circumstances arise, **the carrying amount of the player should be assessed against the best estimate of the player's fair value less any costs to sell and an impairment charge should be recognized in the profit or loss**, which reflects any loss arising.

c) Valuation of stadiums

In terms of Ind AS 113 Fair Value Measurement, stadiums would be valued at the **price which would be received to sell the asset in an orderly transaction between market participants at the measurement date (i.e. exit price)**. The price would be the one which maximizes the value of the asset or the group of assets using the principle of the highest and best use. The price would essentially use Level 2 inputs which are inputs other than quoted market prices included within Level 1 which are observable for the asset or liability, either directly or indirectly. Property naming rights present complications when valuing property. The status of the property indicates its suitability for inviting sponsorship attached to its name. It has nothing to do with the property itself but this can be worth a significant amount. Therefore, Mumbai Challengers Ltd. could include the property naming rights in the valuation of the stadium and write it off over three years.

Ind AS 24 Related Party Disclosures lists the criteria for two entities to be treated as related parties. Such criteria include being members of the same group or where a person or a close member of that person's family is related to a reporting entity if that person has control or joint control over the reporting entity. Ind AS 24 deems that parties are not related simply because they have a director or a key manager in common. In this case, there are three directors in common and in the absence of any information to the contrary, it appears as though the entities are not related. However, the regulator will need to establish whether the sponsorship deal is a related party transaction for the purpose of the financial control provisions. There would need to be demonstrated that the airline may be expected to influence, or be influenced by, the club or a related party of the club. If the deal is deemed to be a related party transaction, the regulator will evaluate whether the sponsorship is at fair value or not.

Case Study 3

- a) Neelanchal Gas Refinery Ltd. (hereinafter referred to as Neelanchal), a listed company, is involved in the production and trading of natural gas and oil. Neelanchal jointly owns an underground storage facility with another entity, Seemanchal Refineries Ltd. (hereinafter referred to as Seemanchal). Both the companies are engaged in extraction of gas from offshore gas fields, which they own and operate independently of each other. Neelanchal owns 60% of the underground facility and Seemanchal owns 40%. Both the companies have agreed to share services and costs accordingly, with decisions relating to the storage facility requiring unanimous agreement of the parties. The underground facility is pressurised so that the gas is pushed out when extracted. When the gas pressure is reduced to a certain level, the remaining gas is irrecoverable and remains in the underground storage facility until it is decommissioned. As per the laws in force, the storage facility should be decommissioned at the end of its useful life.

Neelanchal seeks your advice on the treatment of the agreement with Seemanchal as well as the accounting for the irrecoverable gas.

- b) Neelanchal has entered into a ten-year contract with Uttaranchal Refineries Pvt. Ltd. (hereinafter referred to as Uttaranchal) for purchase of natural gas. Neelanchal has paid an advance to Uttaranchal equivalent to the total quantity of gas contracted for ten years based on the forecasted price of gas. This advanced amount carries interest at the rate of 12.5% per annum, which is settled by Uttaranchal way of supply of extra gas. The contract requires fixed quantities of gas to be supplied each month. Additionally, there is a price adjustment mechanism in the contract whereby the difference between the forecasted price of gas and the prevailing market price is settled in cash on a quarterly basis. If

Uttaranchal does not deliver the gas as agreed, Neelanchal has the right to claim compensation computed at the current market price of the gas.

Neelanchal wants to account for the contract with Uttaranchal in accordance with Ind AS 109 Financial Instruments and seeks your inputs in this regard.

Solution

(a) Joint Arrangement

As per Ind AS 111 Joint Arrangements, a joint arrangement is an arrangement of which two or more parties have 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. The structure and form of the arrangement determines the nature of the relationship. However, irrespective of the purpose, structure or form of the arrangement, the classification of joint arrangements depends upon the parties' rights and obligations arising from the arrangement. Accordingly, a joint arrangement could be classified as a joint operation or as a joint venture. A joint arrangement which is NOT structured through a separate vehicle is a joint operation. In such cases, the contractual arrangement establishes the parties' rights and obligations. A joint operator accounts for the assets, liabilities, revenues and expenses relating to its involvement in a joint operation in accordance with the relevant Ind AS. Based on the information provided, the arrangement with Seemanchal Refineries Ltd. is a joint operation as no separate vehicle is formed and the companies have agreed to share services and costs with decisions regarding the storage facility requiring unanimous agreement of the parties. Neelanchal Gas Refinery Ltd. should recognize its share of the asset as Property, Plant and Equipment.

As per Para 16 of Ind AS 16 Property, Plant and Equipment, the cost of an item of property, plant and equipment comprises the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located. Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets provides guidance on measuring decommissioning, restoration and similar liabilities. Para 45 of Ind AS 37 provides that where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation. Thus, costs incurred by an entity in respect of obligations for dismantling, removing and restoring the site on which an item of property, plant and equipment is situated are recognized and measured in accordance with Ind AS 16 and Ind AS 37, with the journal entry being as under:

Property, Plant and Equipment Dr. xxx

To Provision for Dismantling, Removal and Restoration xxx

Neelanchal Gas Refinery Ltd. should recognize 60% of the cost of decommissioning of the underground storage facility. However, in line Para 29 of Ind AS 37 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 is treated as a contingent liability. Accordingly, Neelanchal Gas Refinery Ltd. should also disclose 40% of the cost of decommissioning of the underground facility as a contingent liability, should there arise future events that prevent Seemanchal Refineries Ltd. from fulfilling its obligations under the arrangement.

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.

Thus, Neelanchal Gas Refinery Ltd. should classify and account for its share of irrecoverable gas as property, plant and equipment, as the irrecoverable gas is necessary for the storage facility to perform its function. Therefore, the irrecoverable gas, being a part of the storage facility, should be capitalized as a component of the storage facility asset, and should be depreciated to its residual value over the life of the storage facility. However, if the gas is recoverable in full upon decommissioning of the storage facility, then depreciation against the irrecoverable gas component will be recorded only if the estimated residual value of the gas decreases below cost during the life of the facility. Upon decommissioning of the storage facility, when the cushion gas is extracted and sold, the sale of irrecoverable gas is accounted as a disposal of an item of property, plant and equipment in accordance with Ind AS 16 and the resulting gain or loss is

recognized in the Statement of Profit and Loss. The natural gas in excess of the irrecoverable gas which is injected into the facility would be treated as inventory in accordance with Ind AS 2 Inventories.

(b) Contract with Uttaranchal Refineries Pvt. Ltd.

As per para 2.4 of Ind AS 109 Financial Instruments, this standard applies to those 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 (i.e. own use contracts). This contract will result in physical delivery of the commodity i.e. extra gas.

Para 2.5 of Ind AS 109 further provides that 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, as if the contract was a financial instrument, may be 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.

There are various ways in which a contract to buy or sell a non-financial item 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.

A written option to buy or sell a non-financial item, such as a commodity, that can be settled net in cash or another financial instrument, or by exchanging financial instruments, is within the scope of Ind AS 109. Such a contract is accounted as a derivative. Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements. Judgment would be required in this area as net settlements caused by unique events beyond management's control may not necessarily prevent the entity from applying the 'own use' exemption to all similar contracts.

In the given case, the contract with Uttaranchal Refineries Pvt. Ltd. will result in physical delivery of extra gas (which is a commodity and not cash, or a financial instrument) for the use of Neelanchal Gas Refinery Ltd. Accordingly, it appears that this contract would be an own use contract falling outside the scope of Ind AS 109 and therefore, would be treated as an executory contract. However, arguments could be placed that the contract is net settled due to the penalty mechanism requiring Uttaranchal Refineries Pvt. Ltd. to compensate Neelanchal Gas Refinery Ltd. at the current prevailing market price. Further, if natural gas is readily convertible into cash at the location of delivery, the contract could be considered net settled. Additionally, if there is volume flexibility, the contract could be regarded as a written option which falls within the scope of Ind AS 109.

However, the contract will probably continue to be regarded as 'own use' as long as it has been entered into and continues to be held for expected counterparties' sale / usage requirements. Additionally, the entity has not irrevocably designated the contract as measured at fair value through profit or loss, thus emphasizing the 'own use' designation.

Case Study 4

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 18 th 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.

Solution

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 31 March 20X2 which comes to ₹ 7.5 lakhs (₹ 10 lakhs * 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.

Case Study 5 (MTP March' 21, Nov'22, May'24)

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. (5 Marks)

Solution

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:

INR

Year	Consideration (Installment)	Present value factor	Present value of consideration
Time of sale	3,33,333	-	3,33,333
End of 1 st year	3,33,333	0.949	3,16,333
End of 2 nd 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		INR	
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

Statement of Profit and Loss (extracts) for the year ended 31st March 20X2 and 31st March 20X3

	As at Mar 31, 20X2	As at Mar 31, 20X3
Income		
Sale of Goods	9,50,000	-
Other Income (Finance income)	33,053	16,947

Balance Sheet (extracts) as at 31st March 20X2 and 31st March 20X3

	As at Mar 31, 20X2	As at Mar 31, 20X3
Assets		
Current Assets		
Financial Assets		
Trade Receivables	3,16,387	XXX

Case Study 6 (MTP Apr'21, May'23)

Master Creator Private Limited (a subsidiary of listed company) is an Indian company to whom Ind AS are applicable. Following draft balance sheet is prepared by the accountant for year ending 31st March 20X2.

Balance Sheet of Master Creator Private Limited as at 31st March, 20X2

Particulars	₹
ASSETS	
Non-current assets	
Property, plant and equipment	85,37,500
Financial assets	
Other financial assets (Security deposits)	4,62,500
Other non-current assets (capital advances) Deferred tax assets	17,33,480
	2,54,150
Current assets	
Trade receivables	7,25,000
Inventories	5,98,050
Financial assets	
Investments	55,000
Other financial assets Cash and cash equivalents	2,17,370
	1,16,950
TOTAL ASSETS	1,27,00,000
EQUITY AND LIABILITIES	
Equity share capital	10,00,000
Non-current liabilities	
Other Equity	25,00,150

Deferred tax liability	4,74,850
Borrowings	64,00,000
Long term provisions	5,24,436
Current liabilities	
Financial liabilities	
Other financial liabilities	2,00,564
Trade payables	6,69,180
Current tax liabilities	9,30,820
TOTAL EQUITY AND LIABILITIES	1,27,00,000

Additional Information:

1. On 1st April 20X1, 8% convertible loan with a nominal value of ₹ 64,00,000 was issued by the entity. It is redeemable on 31st 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 ₹ 5,12,000 has already been paid and included as a finance cost.

Present Value (PV) 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

2. After the reporting period, the board of directors have recommended dividend of ₹ 50,000 for the year ending 31st March, 20X1. However, the same has not been yet accounted by the company in its financials.

3. 'Other current financial liabilities' consists of the following:

Particulars	Amount (₹)
Wages payable	21,890
Salary payable	61,845
TDS payable	81,265
Interest accrued on trade payables	35,564

4. Property, Plant and Equipment consists following items:

Particulars	Amount (₹)	Remarks
Building	37,50,250	It is held for administration purposes
Land	15,48,150	It is held for capital appreciation
Vehicles	12,37,500	These are used as the conveyance for employees
Factory premises	20,01,600	The construction was started on 31st March 20X2 and consequently no depreciation has been charged on it. The construction activities will continue to happen, and it will take 2 years to complete and be available for use.

5. The composition of 'other current financial assets' is as follows:

Particulars	Amount (Rs.)
Interest accrued on bank deposits	57,720
Prepaid expenses	90,000
Royalty receivable from dealers	69,650

6. Current Investments consist of securities held for trading which are carried at fair value through profit & loss. Investments were purchased on 1st January, 20X2 at ₹ 55,000 and accordingly are shown at cost as at 31st March 20X2. The fair value of said investments as on 31st March 20X2 is ₹ 60,000.
7. Trade payables and Trade receivables are due within 12 months.
8. There has been no changes in equity share capital during the year.
9. Entity has the intention to set off a deferred tax asset against a deferred tax liability as they relate to income taxes levied by the same taxation authority and the entity has a legally enforceable right to set off taxes.
10. Other Equity consists retained earnings only. The opening balance of retained earnings was ₹ 21,25,975 as at 1st April 20X1.
11. No dividend has been actually paid by company during the year.
12. Assume that the deferred tax impact, if any on account of above adjustments is correctly calculated in financials.

Being Finance & Accounts manager, you are required to identify the errors and misstatements if any in the balance sheet of Master Creator Private Limited and prepare corrected balance sheet with details on the face of the balance sheet i.e. no need to prepare notes to accounts, after considering the additional information. Provide necessary explanations/workings for the treated items, wherever necessary. **16 Marks**

Solution

Balance Sheet of Master Creator Private Limited as at 31st March, 20X2

Particulars	Working/ Note reference	(₹)
ASSETS		
Non-current assets		
Property, plant and equipment	1	49,87,750
Capital work-in-progress	2	20,01,600
Investment Property	3	15,48,150
Financial assets		
Other financial assets (Security deposits)		4,62,500
Other non-current assets (capital advances)	4	17,33,480
Current assets		
Inventories		5,98,050
Financial assets		
Investments (55,000 + 5,000)	5	60,000
Trade receivables	6	7,25,000
Cash and cash equivalents	7	1,16,950
Other financial assets	8	1,27,370
Other current assets (Prepaid expenses)	8	90,000
TOTAL ASSETS		1,24,50,850
EQUITY AND LIABILITIES		
Equity		
Equity share capital	A	10,00,000
Other equity	B	28,44,606
Non-current liabilities		
Financial liabilities		

8% Convertible loan		
Long term provisions	11	60,60,544
Deferred tax liability		5,24,436
Current liabilities	12	2,20,700
Financial liabilities		
Trade payables		
Other financial liabilities	13	6,69,180
Other current liabilities (TDS payable)	14	1,19,299
Current tax liabilities	15	81,265
		9,30,820
TOTAL EQUITY AND LIABILITIES		1,24,50,850

Statement of changes in equity For the year ended 31st March, 20X2

A. Equity Share Capital

	Balance (₹)
As at 31 st March, 20X1	10,00,000
Changes in equity share capital during the year	-
As at 31 st March, 20X2	<u>10,00,000</u>

B. Other Equity

	Retained Earnings (₹)	Equity component of Compound Financial Instrument (₹)	Total (₹)
As at 31 st March, 20X1	21,25,975	-	21,25,975
Total comprehensive income for the year (25,00,150 + 5,000 - 85,504 - 21,25,975)	2,93,671	-	2,93,671
Issue of compound financial instrument during the year	-	4,24,960	4,24,960
As at 31st March, 20X2	<u>24,19,646</u>	<u>4,24,960</u>	<u>28,44,606</u>

Disclosure forming part of Financial Statements:

Proposed dividend on equity shares is subject to the approval of the shareholders of the company at the annual general meeting and not recognized as liability as at the Balance Sheet date. (Note 9)

Notes/ Workings: (for adjustments/ explanations)

- 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. Therefore, the items of PPE are Buildings (₹ 37,50,250) and Vehicles (₹ 12,37,500), since those assets are held for administrative purposes.
- Property, plant and equipment which are not ready for intended use as on the date of Balance Sheet are disclosed as "Capital work-in-progress". It would be classified from PPE to Capital work-in-progress.
- 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:
 - use in the production or supply of goods or services or for administrative purposes; or
 - sale in the ordinary course of business.

Therefore, Land held for capital appreciation should be classified as Investment property rather than PPE.

4. Assets 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.
5. Current investments here are held for the purpose of trading. Hence, it is a financial asset classified as FVTPL. Any gain in its fair value will be recognised through profit or loss. Hence, ₹ 5,000 (60,000 – 55,000) increase in fair value of financial asset will be recognised in profit and loss.
6. A contractual right to receive cash or another financial asset from another entity is a financial asset. Trade receivables is a financial asset in this case and hence should be reclassified.
7. Cash is a financial asset. Hence it should be reclassified.
8. Other current financial assets:

Particulars	Amount (₹)
Interest accrued on bank deposits	57,720
Royalty receivable from dealers	69,650
Total	1,27,370

Prepaid expenses does not result into receipt of any cash or financial asset. However, it results into future goods or services. Hence, it is not a financial asset.

9. As per Ind AS 10, 'Events after the Reporting Period', If dividends are declared after the reporting period but before the financial statements are approved for issue, the dividends are not recognized 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.
10. 'Other Equity' cannot be shown under 'Non-current liabilities'. Accordingly, it is reclassified under 'Equity'.
11. There are both 'equity' and 'debt' features in the instrument. An obligation to pay cash i.e. interest at 8% per annum and a redemption amount will be treated as 'financial liability' while option to convert the loan into equity shares is the equity element in the instrument. Therefore, convertible loan is a compound financial instrument.

Calculation of debt and equity component and amount to be recognised in the books:

S. No	Year	Interest amount @ 8%	Discounting factor @ 10%	Amount
Year 1	20X2	5,12,000	0.91	4,65,920
Year 2	20X3	5,12,000	0.83	4,24,960
Year 3	20X4	5,12,000	0.75	3,84,000
Year 4	20X5	69,12,000	0.68	47,00,160
Amount to be recognised as a liability				59,75,040
Initial proceeds				(64,00,000)
Amount to be recognised as equity				4,24,960

* In year 4, the loan note will be redeemed; therefore, the cash outflow would be ₹ 69,12,000 (₹ 64,00,000 + ₹ 5,12,000).

Presentation in the Financial Statements:

In Statement of Profit and Loss for the year ended on 31 March 20X2

Finance cost to be recognised in the Statement of Profit and Loss (59,75,040 x 10%)	₹ 5,97,504
Less: Already charged to the Statement of Profit and Loss	(₹ 5,12,000)
Additional finance charge required to be recognised in the Statement of Profit and Loss	₹ 85,504

In Balance Sheet as at 31 March 20X2

Equity and Liabilities	

Equity	
Other Equity (8% convertible loan)	4,24,960
Non-current liability	
Financial liability [8% convertible loan – [(59,75,040+ 5,97,504– 5,12,000)]]	60,60,544

Since entity has the intention to set off deferred tax asset against deferred tax liability and the entity has a legally enforceable right to set off taxes, hence their balance on net basis should be shown as:

Particulars	Amount (₹)
Deferred tax liability	4,74,850
Deferred tax asset	(2,54,150)
Deferred tax liability (net)	<u>2,20,700</u>

13. A liability that is a contractual obligation to deliver cash or another financial asset to another entity is a financial liability. Trade payables is a financial liability in this case.

14. 'Other current financial liabilities':

Particulars	Amount (₹)
Wages payable	21,890
Salary payable	61,845
Interest accrued on trade payables	35,564
Total	<u>1,19,299</u>

15. Liabilities for which there is no contractual obligation to deliver cash or other financial asset to another entity, are not financial liabilities. Hence, TDS payable should be reclassified from 'Other current financial liabilities' to 'Other current liabilities' since it is not a contractual obligation.

Question 1 (RTP - Nov 2018)

Mr. X, is the financial controller of ABC Ltd., a listed entity which prepares consolidated financial statements in accordance with Ind AS. Mr. X has recently produced the final draft of the financial statements of ABC Ltd. for the year ended 31st March, 2018 to the managing director for approval. Mr. Y, who is not an accountant, had raised following queries from Mr. X after going through the draft financial statements:

(a) One of the notes to the financial statements gives details of purchases made by ABC Ltd. from PQR Ltd. during the period. Mr. Y own 100% of the shares in PQR Ltd. However, he feels that there is no requirement for any disclosure to be made in ABC Ltd.'s financial statements since the transaction is carried out on normal commercial terms and is totally insignificant to ABC Ltd., as it represents less than 1% of ABC Ltd.'s purchases.

(b) The notes to the financial statements say that plant and equipment is held under the 'cost model'. However, property which is owner occupied is revalued annually to fair value. Changes in fair value are sometimes reported in profit or loss but usually in 'other comprehensive income'. Also, the amount of depreciation charged on plant and equipment as a percentage of its carrying amount is much higher than for owner occupied property. Another note states that property owned by ABC Ltd. but rent out to others is depreciated annually and not fair valued. Mr. Y is of the opinion that there is no consistent treatment of PPE items in the accounts. Elucidate how all these treatments comply with the relevant Ind AS.

(c) In the year to March, 2018, ABC Ltd. spent considerable amount on designing a new product. ABC Ltd. spent the six months from April, 2017 to September, 2017 researching into the feasibility of the product. Mr. X charged these research costs to profit or loss. From October, 2017, A Ltd. was confident that the product would be commercially successful and A Ltd. is fully committed to finance its future development. A Ltd. spent remaining part of the year in developing the product, which is expected to start from selling in the next few months. These development costs have been recognised as intangible assets in the Balance Sheet. State whether the treatment done by Mr. X is correct when all these research and development costs are design costs. Justify your answer with reference to relevant Ind AS.

Provide answers to the queries raised by the managing director Mr. Y as per Ind AS.

Solution

Ongoing through the queries raised by the Managing Director Mr. Y, the financial controller Mr. X explained the notes and reasons for their disclosures as follows:

(a) Related parties are generally characterised by the presence of control or influence between the two parties.

Ind AS 24 'Related Party Disclosures' identifies related parties as, inter alia, key management personnel and companies controlled by key management personnel. On this basis, PQR Ltd. is a related party of ABC Ltd.

The transaction is required to be disclosed in the financial statements of ABC Ltd. since Mr. Y is Key Management personnel of ABC Ltd. Also at the same time, it owns 100% shares of PQR Ltd. i.e. he controls PQR Ltd. This implies that PQR Ltd. is a related party of ABC Ltd.

Where transactions occur with related parties, Ind AS 24 requires that details of the transactions are disclosed in a note to the financial statements. This is required even if the transactions are carried out on an arm's length basis.

Transactions with related parties are material by their nature, so the fact that the transaction may be numerically insignificant to ABC Ltd. does not affect the need for disclosure.

(b) The accounting treatment of the majority of tangible non-current assets is governed by Ind AS 16 'Property, Plant and Equipment'. Ind AS 16 states that the accounting treatment of PPE is determined on a class by class basis. For this purpose, property and plant would be regarded as separate classes. Ind AS 16 requires that PPE is measured using either the cost model or the revaluation model. This model is

applied on a class by class basis and must be applied consistently within a class. Ind AS 16 states that when the revaluation model applies, surpluses are recorded in other comprehensive income, unless they are cancelling out a deficit which has previously been reported in profit or loss, in which case it is reported in profit or loss. Where the revaluation results in a deficit, then such deficits are reported in profit or loss, unless they are cancelling out a surplus which has previously been reported in other comprehensive income, in which case they are reported in other comprehensive income.

According to Ind AS 16, all assets having a finite useful life should be depreciated over that life. Where property is concerned, the only depreciable element of the property is the buildings element, since land normally has an indefinite life. The estimated useful life of a building tends to be much longer than for plant. These two reasons together explain why the depreciation charge of a property as a percentage of its carrying amount tends to be much lower than for plant.

Properties which are held for investment purposes are not accounted for under Ind AS 16, but under Ind AS 40 'Investment Property'. As per Ind AS 40, investment properties should be accounted for under a cost model. ABC Ltd. had applied the cost model and thus our investment properties are treated differently from the owner occupied property which is annually to fair value.

(c) As per Ind AS 38 'Intangible Assets', the treatment of expenditure on intangible items depends on how it arose. Internal expenditure on intangible items incurred during research phase cannot be recognised as an asset. Once it can be demonstrated that a development project is likely to be technically feasible, commercially viable, overall profitable and can be adequately resourced, then future expenditure on the project can be recognised as an intangible asset. The difference in the treatment of expenditure upto 30th September, 2017 and expenditure after that date is due to the recognition phase i.e. research or development phase.

Question 2 - (PAST EXAM May'19, Nov'19) + (MTP – Oct'20, Aug'18)

Following are the Financial Statements of Abraham Ltd.:

Balance Sheet

Particulars	Note No.	As at 31st March, 2019 (₹ in lakh)
EQUITY AND LIABILITIES:		
Shareholders' funds		
Share capital (shares of ₹ 10 each)		1,000
Reserves and surplus	1	2,400
Non-current liabilities		
Long term borrowings	2	5,700
Deferred tax liabilities	3	400
Current liabilities		
Trade payables		300
Short-term provisions		300
Other current liabilities	4	200
Total		10,300
ASSETS		
Non-current assets		
Fixed assets		5,000
Deferred tax assets	3	700
Current assets		
Inventories		1,500
Trade receivables	5	1,100
Cash and bank balances		2,000

Total	10,300

Statement of Profit & Loss

Particular	Note No.	Year ended 31st March, 2019 (₹ in lakh)
Revenue from operations		6,000
Expenses:		
Employee benefit expense		1,200
Operating costs		3,199
Depreciation		450
Total expenses		4,849
Profit before tax		1,151
Tax expense		201
Profit after tax		950

Notes to Accounts:

Note 1: Reserves and surplus (₹ in lakh)

Capital reserve	500
Surplus from P & L	
Opening balance 550	
Additions 950	1,500
Reserve for foreseeable loss	400
Total	2,400

Note 2: Long-term borrowings

Term loan from bank	5,700
Total	5,700

Note 3: Deferred tax

Deferred tax asset	700
Deferred tax liability	400
Total	300

Note 4: Other current liabilities

Unclaimed dividends	10
Billing in advance	150
Other current liabilities	40
Total	200

Note 5: Trade Receivables

Considered good (outstanding within 6 months)	1,065
Considered doubtful (due from past 1 year)	40
Provision for doubtful debts	(5)
Total	1,100

Additional information:

- (i) Share capital comprises of 100 lakh shares of ₹ 10 each.
- (ii) Term Loan from bank for ₹ 5,700 lakh also includes interest accrued and due of ₹ 700 lakh as on the reporting date.
- (iii) Reserve for foreseeable loss is created against a service contract due within 6 months.
- (iv) Inventory should be valued at cost ₹ 1,500 lakh, NRV as on date is ₹ 1,200 lakh.
- (v) A dividend of 10 % was declared by the Board of directors of the company.
- (vi) Accrued Interest income of ₹ 300 lakh is not booked in the books of the company.
- (vii) Deferred taxes related to taxes on income are levied by the same governing tax laws.

Identify and report the errors and misstatements in the above extracts and prepare corrected Balance Sheet and Statement of Profit & Loss and where required the relevant notes to the accounts with explanations thereof.

Solution:**(12 - 14 Marks)**

Following adjustments / rectifications are required to be done

1. Reserve for foreseeable loss for ₹ 400 lakh, due within 6 months, should be a part of provisions. Hence it needs to be regrouped. If it was also part of previous year's comparatives, a note should be added in the notes to account on the regrouping done this year.
2. Interest accrued and due of ₹ 700 lakh on term loan will be a part of current liabilities.
3. Thus, it should be shown under the heading "Other Current Liabilities".
4. As per Ind AS 2, inventories are measured at the lower of cost and net realisable value. The amount of any write down of inventories to net realisable value is recognised as an expense in the period the write-down occurs. Hence, the inventories should be valued at ₹ 1,200 lakh and write down of ₹ 300 lakh (₹ 1,500 lakh – ₹ 1,200 lakh) will be added to the operating cost of the entity.
5. In the absence of the declaration date of dividend in the question, it is presumed that the dividend is declared after the reporting date. Hence, no adjustment for the same is made in the financial year 2018-2019. However, a note will be given separately in this regard (not forming part of item of financial statements).
6. Accrued income will be shown in the Statement of Profit and Loss as 'Other Income' and as 'Other Current Asset' in the Balance Sheet.
7. Since the deferred tax liabilities and deferred tax assets relate to taxes on income levied by the same governing taxation laws, these shall be set off, in accordance with Ind AS 12. The net DTA of ₹ 300 lakh will be shown in the balance sheet.
8. As per Division II of Schedule III to the Companies Act, 2013, the Statement of Profit and Loss should present the Earnings per Equity Share.
9. In Ind AS, Assets are not presented in the Balance sheet as 'Fixed Asset', rather they are classified under various categories of Non-current assets. Here, it is assumed as 'Property, Plant and Equipment'.
10. The presentation of the notes to 'Trade Receivables' will be modified as per the
11. requirements of Division II of Schedule III.

Balance Sheet of Abraham Ltd. For the year ended 31st March, 2019

	Note No.	(₹ in lakh)
ASSETS		
Non-current assets		
Property, plant and equipment		5,000
Deferred tax assets	1	300
Current assets		
Inventories		1,200

Financial assets		
Trade receivables	2	1,100
Cash and cash equivalents		2,000
Others financial asset (accrued interest)		300
TOTAL		9,900
EQUITY AND LIABILITIES		
Equity		
Equity share capital	3	1,000
Other equity	4	2,000
Non-current liabilities		
Financial liabilities		
Long-term borrowings	5	5,000
Current liabilities		
Financial liabilities		
Trade payables		300
Others	6	710
Short-term provisions (300 + 400)	7	700
Other current liabilities	8	190
TOTAL		9,900

Statement of Profit and Loss of Abraham Ltd.

For the year ended 31st March, 2019

	Note No.	(₹ in lakh)
Revenue from operations		6,000
Other income		<u>300</u>
Total income		<u>6,300</u>
Expenses		
Operating costs	9	3,199
Change in inventories cost		300
Employee benefits expense		1,200
Depreciation		<u>450</u>
Total expenses		<u>5,149</u>
Profit before tax		1,151
Tax expense		<u>(201)</u>
Profit for the period		<u>950</u>
Earnings per equity share		
Basic		9.5
Diluted		9.5
Number of equity shares (face value of ₹ 10 each)		100 lakh

Statement of Changes in Equity of Abraham Ltd.

For the year ended 31st March, 2019

3. Equity Share Capital

(₹ in lakh)

Balance at the beginning of the reporting period	Changes in Equity share capital during the year	Balance at the end of the reporting period
1,000	0	1,000

4. Other Equity

(₹ in lakh)

Particulars	Reserves & Surplus		Total
	Capital reserve	Retained Earnings	
Balance at the beginning of the year	500*	550	1,050
Total comprehensive income for the year		950	950
Balance at the end of the year	500	1,500	2,000

*Note: Capital reserve given in the Note 1 of the question is assumed to be brought forward from the previous year. However, alternatively, if it may be assumed as created during the year.

1. Deferred Tax

(₹ in lakh)

Deferred Tax Asset	700
Deferred Tax Liability	400
	<u>300</u>

2. Trade Receivables

(₹ in lakh)

Trade receivables considered good		1,065
Trade receivables which have significant increase in credit risk	40	
Less: Provision for doubtful debts	(5)	<u>35</u>
Total		<u>1,100</u>

5. Long Term Borrowings

(₹ in lakh)

Term Loan from Bank (5,700 - 700)	5,000
Total	<u>5,000</u>

6. Other Financial Liabilities

(₹ in lakh)

Unclaimed dividends	10
Interest on term loan	700
Total	<u>710</u>

7. Short-term provisions

(₹ in lakh)

Provisions	300
Foreseeable loss against a service contract	400
Total	<u>700</u>

8. Other Current Liabilities

(₹ in lakh)

Billing in Advance	150
Other	40
Total	<u>190</u>

9. Dividends not recognised at the end of the reporting period

At year end, the directors have recommended the payment of dividend of 10% ie ₹ 1 per equity share. This proposed dividend is subject to the approval of shareholders in the ensuing annual general meeting.

Question 3 – (RTP, May'22)

Fresh Vegetables Limited (FVL) was incorporated on 2nd April, 20X1 under the provisions of the Companies Act, 2013 to carry on the wholesale trading business in vegetables. As per the audited accounts of the financial year ended 31st March, 20X7 approved in its annual general meeting held on 31st August, 20X7 its net worth, for the first time since incorporation, exceeded ₹ 250 crore. The financial statements since inception till financial year ended 31st March, 20X6 were prepared in accordance with the Companies (Accounting Standards) Rules 2006. It has been advised that henceforth it should prepare its financial statements in accordance with the Companies (Indian Accounting Standards) Rules, 2015.

The following additional information is provided by the Company:

- FVL has in the financial year 20X2-20X3 entered into a 60:40 partnership with Logistics Limited and incorporated a partnership firm 'Vegetable Logistics Associates' (VLA) to carry on the logistics business of vegetables from farm to market.
- FVL also has an associate company Social Welfare Limited (SWL) that was incorporated in July, 20X5 as a charitable organization and registered under section 8 of the Companies Act, 2013. Social Welfare Limited has been the associate company of FVL since its incorporation.

Examine the applicability of Ind AS on VLA & SWL.

Solution:

Applicability of Ind AS in general:

- Currently Ind AS is applicable to the following companies except for companies other than banks and Insurance Companies, on mandatory basis:
 - (a) All companies which are listed or in process of listing in or outside India on Stock Exchanges.
 - (b) Unlisted companies having net worth of ₹ 250 crore or more but less than ₹ 500 crore.
 - (c) Holding, Subsidiary, Associate and Joint venture of above.
- Companies listed on SME exchange are not required to apply Ind AS on mandatory basis.
- Once a company starts following Ind AS either voluntarily or mandatorily on the basis of criteria specified, it shall be required to follow Ind AS for all the subsequent financial statements even if any of the criteria specified does not subsequently apply to it.
- Application of Ind AS is for both standalone as well as consolidated financial statements if threshold criteria met or adopted voluntarily.
- Companies meeting the thresholds for the first time at the end of an accounting year shall apply Ind AS from the immediate next accounting year with comparatives.
- Companies not covered by the above roadmap shall continue to apply existing Accounting Standards notified in the Companies (Accounting Standards) Rules, 2006.

Since the net worth of FVL in immediately preceding year exceeded ₹ 250 crore, Ind AS is applicable to it. The entity VLA and SWL have to be examined as they may fall in criteria (c) above.

Applicability of Ind AS on VLA

Joint arrangement can be either joint operation or joint venture. However, for the purpose of identifying the applicability of Ind AS, the Act defines Joint venture (as an explanation to section 2(6) of the Companies Act, 2013), as follows:

"The expression 'joint venture' means a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement".

Accordingly, if an entity is classified as joint operation and not joint venture, then Ind AS would not be applicable to such entity.

In the case of VLA, if partners conclude that they have rights in the assets and obligations for the liabilities relating to the partnership firm then this would be a joint operation. However, Ind AS would not be applicable on VLA in such a case since it is the case of joint operation (and not a joint venture).

Alternatively, if partners conclude that they have joint control of the arrangement and have rights to the net assets of the arrangement relating to the partnership firm, then this would be a joint venture. In such a case, Ind AS would be applicable to them.

Applicability of Ind AS on SWL

Social Welfare Limited (SWL) is the associate company of FVL. Accordingly, Ind AS would be applicable on SWL too irrespective of the fact that SWL has been incorporated as a charitable organisation.

INTRODUCTION TO IND AS

Illustration 1

Following is a snapshot of audited balance sheet of company A as on 31st March 2014. Company A's equity shares are listed on Bombay Stock Exchange since 2010.

Liabilities	₹ in crores	Assets	₹ in crores
Equity Share Capital	160	Fixed Assets	455
Securities Premium	200	Investments	200
General Reserve	150	Current Assets	50
Revaluation Reserve	40	Miscellaneous Expenditure not w/off	80
Profit and Loss A/c	75		
Liabilities	160		
Total	785	Total	785

- As per roadmap, which Phase company A fall into?
- Will your answer change if Company A is an unlisted company?

Solution

Calculation of Net Worth:

Particulars	₹ in crores
Equity Share Capital	160
Securities Premium	200
General Reserve	150
Profit and Loss A/c	75
Miscellaneous Expenditure not written off	(80)
Net Worth as per Section 2(57) of The Companies Act, 2013	505

Note – Revaluation Reserve would not be included in the calculation of net worth as per definition mentioned in section 2(57) of The Companies Act, 2013

The company is a listed company and it does meet the net worth threshold of ₹ 500 Crores. Hence it would be covered under phase I. Hence Ind AS would be applicable to the company for accounting periods beginning on or after 1st April 2016.

Even if Company A is an unlisted company as company A's net worth is more than 500 Crores, it would be covered under Phase I of the road map and hence Ind AS would be applicable for the accounting periods beginning on or after 1st April 2016.

Illustration 2

Let's say in Illustration 1, the balance of profit and loss account is negative ₹ 375 crores. When Ind AS should be applicable to Company A? Will your answer change if Company A is an unlisted company?

Solution

If the balance of Profit and Loss A/c is negative 375 Crores, the net worth as per section 2(57) of The Companies Act, 2013 would be ₹ 55 Crores (Equity share capital ₹ 160 Cr + Securities Premium ₹ 200 Cr + General Reserve ₹ 150 Cr – Debit balance of P&L ₹ 375 Cr – Miscellaneous expenditure not written off ₹ 80 Cr). Hence, it does not meet the criteria as mentioned in Phase I i.e. Listed company or Net worth of ₹ 500 Cr or more.

However, as Company A is a listed company, it will irrespective be covered under Phase II as the first criteria of phase II states "companies whose equity or debt securities are listed or are in the process of being listed on any stock exchange in India or outside India and having net worth of less than rupees five hundred crore". Hence, Ind AS would be applicable to Company A for the accounting periods beginning on or after 1st April 2017.

If Company A is an unlisted company, Ind AS would not be applicable until it breaches the net worth criteria mentioned in the roadmap.

Illustration 3

The net worth of Company B (an unlisted company) was ₹ 600 crores as on 31st March 2014. However due to losses incurred in FY 14-15, the net worth of the company was ₹ 400 Crores as on 31st March 2015. From when company B shall apply Ind AS?

Solution

Here the company's net worth as on cut-off date was greater than ₹ 500 crores, which suggests that it should be covered under phase I of the roadmap. A question may however arise in mind that since, the net worth as on immediately preceding year-end was ₹ 400 crores, would the company be covered under phase II of the roadmap?

"It may be noted that the net worth shall be calculated in accordance with the stand-alone financial statements of the company as on 31st March, 2014. Accordingly, if the net worth threshold criteria for a company are once met, then it shall be required to comply with Ind AS, irrespective of the fact that as on later date its net worth falls below the criteria specified."

In view of the above, the Company B will be required to follow Ind AS for accounting periods beginning on or after 1st April 2016.

Illustration 4

The net worth of Company C (an unlisted company) was ₹ 400 crores as on 31st March 2014. However, the net worth of the company was ₹ 600 Crores as on 31st March 2015. From when company B shall apply Ind AS?

Solution

Similar issue has been encountered in ITFG Bulletin 1, Issue 1 which gives reference to clause 2b of the notification wherein it is stated that:

"For companies which are not in existence on 31st March, 2014 or an existing company falling under any of thresholds specified in sub-rule (1) for the first time after 31st March, 2014, the net worth shall be calculated on the basis of the first audited financial statements ending after that date in respect of which it meets the thresholds specified in sub-rule (1)"

Hence, any company that meets the thresholds as specified in the Companies (Indian Accounting Standards) Rules, 2015 in a particular financial year, Ind AS will become applicable to such company in immediately next financial year. Hence, in the present case, Company C is covered by Phase I of the roadmap and accordingly, Ind AS will be applicable to Company C for accounting periods beginning on or after 1st April 2016

Illustration 5

Company D is the parent company of group A. Company A is an unlisted company having net worth of 60 crores as on 31st March 2014. Following are the other companies of the group.

Name of the company	Relationship	Net worth as on 31st March 2014
Company B (Unlisted)	Subsidiary of Company A	600 Crore
Company C (Unlisted)	Subsidiary of Company B	150 Crore

Whether Ind AS be applicable to companies A, B and C?

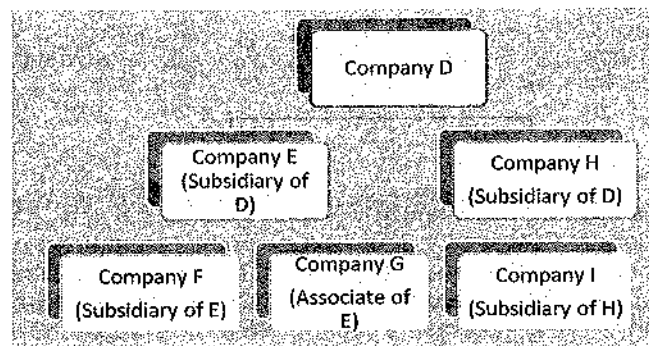
Solution

Company A and C are¹unlisted and do not exceed the net worth criteria. However, the net worth of Company B exceeds ₹ 500 Crore hence it would be covered under Phase I of the roadmap.

As Ind AS be applicable to Company B, the parent company of Company B i.e. Company A and subsidiary of Company B i.e. Company C would also get covered under Ind AS irrespective of net worth criteria. Hence Ind AS would be applicable to all three companies i.e. Company A, B and C

Illustration 6

Following is the structure of Company D



All the companies in above structure are unlisted companies and the net worth of company E is ₹ 300 Crores and net worth of all the other companies is below ₹ 250 crores. To which company would Ind AS be applicable?

Solution

As mentioned in the Companies (Indian Accounting Standards) Rules, 2015, if Ind AS is applicable to a company, it would also be applicable to its Holding Company, subsidiary company, associate company and Joint Venture.

As the turnover of company E is above ₹ 250 crores, it would be covered under Phase II of the roadmap. Hence, its subsidiary (Company F), associate (Company G) and Holding (Company D) would also be covered under Ind AS with effect from 1st April 2017.

With respect to other companies of the group, following guidance is given in ITFG clarification bulletin 15, Issue 10: "It may be noted that Ind AS applies to holding, subsidiary, joint venture and associate companies of the companies which meet the net worth/listing criteria. This requirement does not extend to another fellow subsidiary of a holding company which is required to adopt Ind AS because of its holding company relationship with a subsidiary meeting the net worth/listing criteria. Holding company will be required to prepare separate and consolidated financial statements mandatorily under Ind AS, if one of its subsidiaries meets the specified criteria and therefore, such subsidiaries may be required by the holding company to furnish financial statements as per Ind AS for the purpose of preparing Holding company's consolidated Ind AS financial statements. Such fellow subsidiaries may, however, voluntarily opt to prepare their financial statements as per Ind AS."

Hence the other companies of the group i.e. Company H and Company I would not be covered under Ind AS. However, as mentioned in ITFG, Company H and I would be required to prepare its financial statements under Ind AS so as to facilitate Company D for preparation of its consolidated financial statements. Hence, though statutorily Company H and I may continue to prepare its financial statements under AS, but it will also have to converge to Ind AS. Moreover, they may also opt to voluntarily adopt Ind AS and prepare its statutory accounts under Ind AS too.

Illustration 7

ABC Inc., incorporated in a foreign country has a net worth of ₹ 700 Crores. It has two subsidiaries Company X whose net worth as on 31st March 2014 is ₹ 600 Crores and Company Y whose net worth is ₹ 150 Crores. Whether Company X and Y would be required to follow Ind AS from accounting periods commencing on or after 1st April 2016 on the basis of their own net worth or on the basis of the net worth of ABC Inc.?

Solution

Similar issue has been dealt in ITFG Clarification Bulletin 2, Issue 2. ITFG noted that as per Rule 4(1)(ii)(a) of the Companies (Indian Accounting Standards) Rules, 2015, Company X having net worth of ₹ 600 crores at the end of the financial year 2015-16, would be required to prepare its financial statements for the accounting periods commencing from 1st April, 2016, as per the Companies (Indian Accounting Standards) Rules, 2015. While Company Y Ltd. having net worth of ₹ 150 crores in the year 2015-16, would be required to prepare its financial statements as per the Companies (Accounting Standards) Rules, 2006.

Since, the foreign company ABC Inc., is not a company incorporated under the Companies Act, 2013 or the earlier Companies Act, 1956, it is not required to prepare its financial statements as per the Companies (Indian Accounting Standards) Rules, 2015. As the foreign company is not required to prepare financial statements based on Ind AS, the net worth of foreign company ABC would not be the basis for deciding whether Indian Subsidiary Company X Ltd. and Company Y Ltd. are required to prepare financial statements based on Ind AS.

Illustration 8

As per the roadmap, Ind AS is applicable to Company X from the financial year 2017-18. Company X (non-finance company) is a subsidiary of Company Y (NBFC). Company Y is an unlisted NBFC company having net worth of ₹ 400 crores. What will be the date of applicability of Ind AS for company X and company Y? If Ind AS applicability date for parent NBFC is different from the applicability date of corporate subsidiary, then, how will the consolidated financial statements of parent NBFC be prepared?

Solution

In accordance with the roadmap, it may be noted that NBFCs having net worth of less than 500 crore shall apply Ind AS from 1 April, 2019 onwards. Further, the holding, subsidiary, joint venture or associate company of such an NBFC other than those covered by corporate roadmap shall also apply Ind AS from 1 April, 2019.

Accordingly, in the given case, Company Y (NBFC) shall apply Ind AS for the financial year beginning 1 April, 2019 with comparative for the period ended 31 March, 2019. Company X shall apply Ind AS in its statutory individual financial statements from financial year 2017-2018 (as per the corporate roadmap). However, for the purpose of Consolidation by Company Y for financial years 2017-2018 and 2018-2019, Company X shall also prepare its individual financial statements as per AS.

Question 1 (MTP May'24)

Which entities are required to prepare their financial statements mandatorily on the basis of Indian Accounting Standards (Ind AS)? **(4 Marks)**

Solution:

Following entities are mandatorily required to prepare their financial statements based on Indian Accounting Standards

- All Listed Corporate Entities
- Unlisted Corporate Entities having net worth of rupees two hundred and fifty crore or more
- All holding, subsidiary, joint venture or associate companies of the above mentioned listed and unlisted corporate entities
- All Listed NBFCs
- Unlisted NBFCs having net worth of rupees two hundred and fifty crore or more
- MF schemes

CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING UNDER IND AS

Illustration 1

Derecognition vs. Faithful Representation

As at 31 March 20X2, Natasha Ltd. carried trade receivables of ₹ 280 crores in its balance sheet. At that date, Natasha Ltd. entered into a factoring agreement with Samantha Ltd., a financial institution, according to which it transferred the trade receivables in exchange for an immediate cash payment of ₹ 250 crores. As per the factoring agreement, any shortfall between the amount collected and ₹ 250 crores will be reimbursed by Natasha Ltd. to Samantha Ltd. Once the trade receivables have been collected, any amounts above ₹ 250 crores, less interest on this amount, will be repaid to Natasha Ltd. The directors of Natasha Ltd. are of the opinion that the trade receivables should be derecognized.

You are required to explain the appropriate accounting treatment of this transaction in the financial statements for the year ending 31 March 20X2, and also evaluate this transaction in the context of the Conceptual Framework.

Solution

Accounting Treatment:

Trade Receivables fall within the ambit of financial assets under Ind AS 109, Financial Instruments. Thus, the issue in question is whether the factoring arrangement entered into with Samantha Ltd. requires Natasha Ltd. to derecognize the trade receivables from its financial statements.

As per Para 3.2.3, 3.2.4, 3.2.5 and 3.2.6 of Ind AS 109, Financial Instruments, an entity shall derecognise a financial asset when, and only when:

- (a) the contractual rights to the cash flows from the financial asset expire, or
- (b) it transfers the financial asset or substantially all the risks and rewards of ownership of the financial asset to another party.

In the given case, since the trade receivables are appearing in the Balance Sheet of Natasha Ltd. as at 31 March 20X2 and are expected to be collected, the contractual rights to the cash flows have not expired.

As far as the transfer of the risks and rewards of ownership is concerned, the factoring arrangement needs to be viewed in its substance, rather than its legal form. Natasha Ltd. has transferred the receivables to Samantha Ltd. for cash of ₹ 250 crores, and yet, it remains liable for making good any shortfall between ₹ 250 crores and the amount collected by Samantha Ltd. Thus, in substance, Natasha Ltd. is effectively liable for the entire ₹ 250 crores, although the shortfall would not be such an amount. Accordingly, Natasha Ltd. retains the credit risk despite the factoring arrangement entered.

It is also explicitly stated in the agreement that Samantha Ltd. would be liable to pay to Natasha Ltd. any amount collected more than ₹ 250 crores, after retaining an amount towards interest. Thus, Natasha Ltd. retains the potential rewards of full settlement.

A perusal of the above clearly shows that substantially all the risks and rewards continue to remain with Natasha Ltd., and hence, the trade receivables should continue to appear in the Balance Sheet of Natasha Ltd. The immediate payment (i.e. consideration as per the factoring agreement) of ₹ 250 crores by Samantha Ltd. to Natasha Ltd. should be regarded as a financial liability, and be shown as such by Natasha Ltd. in its Balance Sheet.

Illustration 2 – (Past Exam Nov'22)

Explain the criteria in the Conceptual Framework for Financial Reporting for the recognition of an asset and discuss whether there are inconsistencies with the criteria in Ind AS 38, Intangible Assets. (6 Marks)

Solution:

The Conceptual Framework defines an asset as a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits. Assets should be recognized if they meet the Conceptual Framework definition of an asset and such

recognition provides users of financial statements with information that is useful (i.e. it is relevant as well as results in faithful representation). However, the criteria of a cost-benefit analysis always exists i.e. the benefits of the information must be sufficient to justify the costs of providing such information. The recognition criteria outlined in the Conceptual Framework allows for flexibility in the application in amending or developing the standards.

Para 8 of Ind AS 38, Intangible Assets defines an intangible asset as an identifiable non-monetary asset without physical substance. Further, Ind AS 38 defines an asset as 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.

Furthermore, Para 21 of Ind AS 38 states that an intangible asset shall be recognised 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.

This requirement is applicable both in case of an externally acquired intangible asset or an internally generated intangible asset. The probability of expected future economic benefits must be based on 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. Further, as per Para 33 of Ind AS 38, the probability recognition criterion is always considered to be satisfied for intangible assets acquired in business combinations. If the recognition criteria are not satisfied, Ind AS 38 requires the expenditure to be expensed as and when it is incurred.

It is notable that the Conceptual Framework does not prescribe a 'probability criterion'. As long as there is a potential to produce economic benefits, even with a low probability, an item can be recognized as an asset according to the Conceptual Framework. However, in terms of intangible assets, it could be argued that recognizing an intangible asset having low probability of generating economic benefits would not be useful to the users of financial statements given that the asset has no physical substance.

The recognition criteria and definition of an asset under Ind AS 38 are different as compared to those outlined in the Conceptual Framework. To put in simple words, the criteria in Ind AS 38 are more specific, but definitely do provide information that is relevant and a faithful representation. When viewed from the prism of relevance and faithful representation, the requirements of Ind AS 38 in terms of recognition appear to be consistent with the Conceptual Framework.

Illustration 3

The directors of Hind Ltd. are particular about the usefulness of the financial statements. They have opined that although Ind AS implement a fair value model, Ind AS are failing in reflecting the usefulness of the financial statements as they do not reflect the financial value of the entity.

Discuss the views of the directors as regards the use of fair value in Ind AS and the fact that the Ind AS do not reflect the financial value of an entity, making.

Solution:

Usage of Fair Value in Ind AS:

Treatment under Ind AS:

The statement of the directors regarding Ind AS implementing a fair value model is not entire accurate. Although Ind AS do use fair value (and present value), it is not a complete fair value system. Ind AS are often based on the business model of the entity and on the expectations of realizing the asset- and liability-related cash flows through operations and transfers.

It is notable that what is preferred is a mixed measurement system, with some items being measured at fair value while others measured at historical cost.

About Fair Value (Ind AS 113)

Ind AS 113 defines fair value as 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. This price is an exit price.

Ind AS 113 has given consistency to the definition and application of fair value, and this consistency is applied across other Ind AS, which are generally required to measure fair value in accordance with Ind AS 113. However, it cannot be implied that Ind AS requires all assets and liabilities to be measured at fair value. Rather, many entities measure most items at depreciated historical costs, although the exception being in the case of business combinations, where assets and liabilities are recorded at fair value on the date of acquisition. In other cases, usage of fair value is restricted.

Examples of use of fair value in Ind AS:

- (a) Ind AS 16 Property, Plant and Equipment permits revaluation through other comprehensive income, provided it is carried out regularly.
- (b) Disclosure of fair value of Investment Property in Ind AS 40, while the companies account for the same under the cost model.
- (c) Ind AS 38 Intangible Assets allows measurement of intangible assets at fair value with corresponding changes in equity, but only if the assets can be measured reliably by way of existence of an active market for them.
- (d) Ind AS 109 Financial Instruments requires some financial assets and liabilities to be measured at amortized cost and others at fair value. The measurement basis is largely determined by the business model for that financial instrument. Where the financial instruments are carried at fair value, depending on the category and circumstances, the movement in the fair value (gain or loss) is either recognized in profit or loss or in other comprehensive income.

Financial value of an entity

Although Ind AS makes use of fair values in the measurement of assets and liabilities, the financial statements prepared under Ind AS are not intended to reflect the aggregate value of the entity, as could be the notion among people. As discussed in 2.2 above, the Conceptual Framework specifically states that general purpose financial statements are not intended to show the value of a reporting entity. Furthermore, such an attempt would not be fruitful as certain internally generated intangible assets cannot be recognized under Ind AS. Instead, the objective of general purpose financial reports is to provide financial information about the reporting entity which would be useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

It is only in the case of acquisition of an entity by another entity and subsequent consolidation in group accounts that an entity's net assets are reported at fair value.

Illustration 4

Everest Ltd. is a listed company having investments in various subsidiaries. In its annual financial statements for the year ending 31 March 20X2 as well as 31 March 20X3, Everest Ltd. classified Kanchenjunga Ltd. a subsidiary as 'held-for-sale' and presented it as a discontinued operation. On 1 November 20X1, the shareholders had authorized the management to sell all of its holding in Kanchenjunga Ltd. within the year. In the year to 31 March 20X2, the management made a public announcement of its intention to sell the investment but did not actively try to sell the subsidiary as it was still operational within the Everest group.

Certain organizational changes were made by Everest Ltd. during the year to 31 March 20X3, thereby resulting in additional activities being transferred to Kanchenjunga Ltd. Additionally, during the year ending 31 March 20X3, there had been draft agreements and some correspondence with investment bankers, which showed in principle only that Kanchenjunga was still for sale.

Discuss whether the classification of Kanchenjunga Ltd. as held for sale and its presentation as a discontinued operation is appropriate, by referring to the principles notes.

Solution:

Kanchenjunga Ltd. is a disposal group in accordance with Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations. Disposal group can be defined as 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.

Para 6 of Ind AS 105 provides that a disposal group shall be classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. Ind AS

105 is particularly strict as far as the application of held for sale criteria is concerned, and often the decision to sell an asset or a disposal group is made well before the criteria are met.

Thus, as per Ind AS 105, for the asset (or disposal group) to be classified as held for sale, it 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.

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).
- ✓ An active programme to locate a buyer and complete the plan must have been initiated.
- ✓ The asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value.
- ✓ The sale should be expected to qualify for recognition as a completed sale within one year from the date of classification.
- ✓ It is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

In the given case, the draft agreements and correspondence with investment bankers are not specific enough to fit in the points above to prove that the criteria for held for sale was met at that date. Additional information would be needed to confirm that the subsidiary was available for immediate sale, and that it was being actively marketed at an appropriate price so as to satisfy the criteria in the year to 31 March 20X2.

Further, the organizational changes made by Everest Ltd. in the year 20X2-20X3 are a good indicator that Kanchenjunga Ltd. was not available for immediate sale in its present condition at the point of classification. The fact that additional activities have been given to Kanchenjunga Ltd. indicate that the change wasn't insignificant. The shareholders had authorized for a year from 1 November 20X1. There is no evidence that this authorization extended beyond 1 November 20X2.

Conclusion:

Based on the information provided in the given case, it appears that Kanchenjunga Ltd. should not be classified by Everest Ltd. as a subsidiary held for sale. Instead, the results of the subsidiary should be reported as a continuing operation in the financial statements for the year ending 31 March 20X2 and 31 March 20X3.

Evaluation of treatment in context of the Conceptual Framework

The Conceptual Framework states that the users need information to allow them to assess the amount, timing and uncertainty of the prospects for future net cash inflows. Highlighting the results of discontinued operations separately equips users with the information that is relevant to this assessment as the discontinued operation will not contribute to cash flows in the future.

If a company has made a firm decision to sell the subsidiary, it could be argued that the subsidiary should be classified as discontinued operation, even if the criteria to classify it as 'held for sale' as per Ind AS 105 have not been met, because this information would be more useful to users. However, Ind AS 105 criteria was developed with high degree of strictness on classification. Accordingly, this decision could be argued to be in conflict with the Conceptual Framework.

Illustration 5

The directors of Jayant Ltd. have received the following email from its majority shareholder:

To: Directors of Jayant Ltd. Re: Measurement

I recently read an article published in the financial press about the 'mixed measurement approach' that is used by lots of companies. I hope Jayant Ltd. does not follow such an approach because 'mixed' seems to imply 'inconsistent'. I believe that consistency is of paramount importance, and hence feel it would be better to measure everything in a uniform manner. It would be appreciated if you could provide further information at the next annual general meeting on measurement bases, covering what approach is taken by Jayant Ltd. and why, and the potential effect such an approach has on the investors trying to analyse the financial statements.

Prepare notes for the directors of Jayant Ltd. to discuss the issue raised in the shareholders' email with reference to the Conceptual Framework wherever appropriate.

Solution

'Mixed measurement' approach implies that a company selects different measurement bases (e.g. historical cost or fair value) for its various assets and liabilities, rather than using one single measurement basis for all items. The measurement basis so selected should reflect the type of entity and the sector in which it operates and the business model that the entity adopts.

There are criticisms of the mixed measurement approach, particularly under the IFRS regime, because investors think that if different measurement bases are used for assets and liabilities, the resulting figures could lack relevance or exhibit little meaning.

It is however important to note that figures of items in the financial statements cannot be derived by following a one-size-fits-all approach. Such an approach may not provide relevant information to users. A particular measurement basis may be easier to understand, more verifiable and less costly to implement. Therefore, to state that 'mixed measurement' approach is 'inconsistent' is a poor argument. In reality, a mixed approach may actually provide more relevant information to the stakeholders.

The Conceptual Framework confirms the allowance of the usage of a mixed measurement approach in developing standards. The measurement methods included in the standards are those which the standard-setters believe provide the most relevant information and which most faithfully represent the underlying transaction or event. Based on the reactions to the convergence to Ind AS, it feels that most investors feel this approach is consistent with their analysis of financial statements. Thus, the arguments against a mixed measurement are far outweighed by the greater relevance achieved by such measurement bases.

Jayant Ltd. prepares its financial statements under Ind AS, and therefore applies the measurement bases permitted in Ind AS. Ind AS adopt a mixed measurement basis, which includes current value (fair value, value in use, fulfilment value and current cost) and historical cost.

Where an Ind AS allows a choice of measurement basis, the directors of Jayant Ltd. must exercise judgment as to which basis will provide the most useful information for its primary users. Furthermore, when selecting a measurement basis, measurement uncertainty should also be considered. The Conceptual Framework states that for some estimates, a high level of measurement uncertainty may outweigh other factors to such an extent that the resulting information may be of little relevance.

Question 1 – (Past Exam May'22, Nov'23)

Discuss the following in the context of 'Conceptual Framework for Financial Reporting under Indian Accounting Standards':

- (i) The cost constraint on useful financial information
- (ii) Executory contracts

(6 Marks)**Solution:**

- (i) **The cost constraint on useful financial information;**

Role of Cost: Cost is a pervasive constraint on the information that can be provided by financial reporting. Reporting financial information imposes costs, and it is important that these costs are justified by the benefits of reporting that information.

Basis of Assessment of Cost: Both the providers and users of financial information incur costs in reporting and analysing financial information. In applying the cost constraint, ICAI assesses whether the benefits of reporting particular information are likely to justify the costs incurred to provide and use that information. When applying the cost constraint in formulating a proposed Ind AS, the ICAI seeks information from providers of financial information, users, auditors, academics and others about the expected nature and quantity of the benefits and costs of that Ind AS. In most situations, assessments are based on a combination of quantitative and qualitative information.

Cost Perspective: Due to the inherent subjectivity, assessments of different individuals about the costs and benefits of reporting particular items of financial information will vary. Therefore, ICAI seeks to consider costs and benefits in relation to financial reporting generally, and not just in relation to individual reporting entities.

- (ii) **Executory Contracts:**

Definition: An executory contract is a contract, or a portion of a contract, that is equally unperformed — neither party has fulfilled any of its obligations, or both parties have partially fulfilled their obligations to an equal extent.

Outcome of Executory Contract: An executory contract establishes a combined right and obligation to exchange economic resources. The rights and obligations are inter-dependent and cannot be separated. Hence, the combined rights and obligations constitute a single asset or liability.

The entity has an asset if the terms of the exchange are currently favourable; it has a liability if the terms of the exchange are currently unfavourable.

Basis of Disclosure: Whether such an asset or liability is included in the financial statements depends on both the recognition criteria and the measurement basis selected for the asset or liability, including, if applicable, any test for whether the contract is onerous.

Question 2 (RTP May'22) (MTP May'23)

Defense Innovators Limited is a public sector undertaking and is engaged in the construction of warships and submarines. XYZ Private Limited approached Defense Innovators Limited for construction of "specially designed" ships for it, which will be used by XYZ Private Limited for transportation of specific goods. The offer was accepted by the Defense Innovators Limited and both the companies entered into an agreement for the construction and delivery of 3 specially designed ships on 'Fixed Price' basis with variable component in respect to certain items.

Base and depot (B & D) spares for all three ships shall be procured by Defense Innovators Limited and will be paid on the cost of the item with certain percentage.

The contract states that "certain equipment" out of variable cost items, will be supplied by XYZ Private Limited at 'free of cost' for installation on board of ship. It is, therefore, to be noted as under:

- i) Some equipment are procured by Defense Innovators Limited in the presence of the XYZ Private Limited's representative for technical scrutiny as well as negotiating the prices. The vendors of these equipment are paid by Defense Innovators Limited. The cost of the equipment along with the cost of installation and profit thereon is claimed and reimbursed by XYZ Private Limited to Defense Innovators Limited.

- ii) There are certain other equipment for which orders are directly placed and also paid by the XYZ Private Limited. These equipment are known as 'Buyer Furnished Equipment (BFE)' and are delivered to the company 'free of cost' for installing in the ship. The labour cost of Installation of these are already included in the price component of the contract. BFEs are returned to the buyer after completion of the ship.

The period required for construction of one ship was approximately four years.

Whether the cost of Buyer Furnished Equipment's (BFE's) supplied by XYZ Private Limited to Defense Innovators Limited for installing the same in the ships can be considered as 'inventory' by Defense Innovators Limited and then on delivery of ship will be recognised as revenue in its books of account? Elaborate.

(6 Marks)

Solution:

Before any item can be recognised as an inventory, it should meet the definition of 'asset' as given in the Conceptual Framework for Financial Reporting under Ind AS, issued by the Institute of Chartered Accountants of India as follows:

"An asset is a present economic resource controlled by the entity as a result of past events and economic resource is a right that has the potential to produce economic benefits".

The orders in respect of Buyer Furnished Equipment's (BFEs) are directly placed by the buyer and payment in respect of them is made by the buyer. These are then supplied to the company for installing in the ship and the buyer pays installation charges which are included in the contract price. Thus, the company has neither incurred any cost on BFEs nor any amount is recoverable on account of such equipment except installation charges. Accordingly, such equipment are not 'assets' that may be considered as a part of its contract work-in progress.

In fact, after installation in the ship, BFEs are returned to the buyer after completion of the ship. Thus, these are only held by the company in the capacity of a bailee. Since, it cannot be considered as an 'asset', therefore, it can neither be considered as 'inventory' nor as 'work-in-progress'.

Further, it can also not be considered as a part of sale value or revenue of the company as no consideration would be receivable with respect to the cost of such equipment.

On the basis of the above, it can be concluded that:

- i) The BFEs cannot be considered as inventories / Work-in-progress for Defense Innovators Limited.
- ii) The BFE's cost cannot be considered as part of sales value / contract revenue to Defense Innovators Limited.

Question 3 (MTP Nov'22)

What is Equity, Income and Expenses as per 'Framework for Financial Reporting under Ind AS'? How the information with respect to income and expenses helps the users in understanding of the financial statements?

(5 Marks)

Solution:

Equity: Equity claims are claims on the residual interest in the assets of the entity after deducting all its liabilities. In other words, they are claims against the entity that do not meet the definition of a liability.

Income and Expenses: Income is increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.

Expenses are decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.

Income and expenses are the elements of financial statements that relate to an entity's financial performance. Users of financial statements need information about both an entity's financial position and its financial performance. Hence, although income and expenses are defined in terms of changes in assets and liabilities, information about income and expenses is just as important as information about assets and liabilities. Different transactions and other events generate income and expenses with different characteristics. Providing information separately about income and expenses with different characteristics can help users of financial statements to understand the entity's financial performance.

Question 4 (Past Exam May'23)

Discuss with respect to 'Conceptual Framework for Financial Reporting under Indian Accounting Standards', 'faithful representation', one of the qualitative characteristics of financial information. (6 Marks)

Solution:**Faithful representation**

To be useful, financial information must faithfully represent the substance of the phenomena that it purports to represent. In many circumstances, the substance of an economic phenomenon and its legal form are the same. If they are not the same, providing information only about the legal form would not faithfully represent the economic phenomenon.

To be a perfectly faithful representation, a depiction would have following three characteristics:

- **Complete:** A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.
- **Neutral:** A neutral depiction is without bias in the selection or presentation of financial information. Neutrality is supported by the exercise of prudence. Prudence is the exercise of caution when making judgements under conditions of uncertainty. The exercise of prudence means that assets and income are not overstated, and liabilities and expenses are not understated. Equally, the exercise of prudence does not allow for the understatement of assets or income or the overstatement of liabilities or expenses.
- **Free from error:** Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. In this context, being free from error does not mean perfectly accurate in all respects. For example, an estimate of an unobservable price or value cannot be determined to be accurate or inaccurate. However, a representation of that estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate.

Question 5 (Past Exam Nov'23)

Discuss the characteristics of good financial statements.

(6 Marks)

Solution:

Characteristics of good financial information are:

1. Relevance

"Relevant financial information"

- Is financial information with (a) predictive value or (b) confirmatory value or both
- Makes it capable of making a difference in decisions made by users
- Makes it relevant financial information

Financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes. Financial information need not be a prediction or forecast to have predictive value. Financial information with predictive value is employed by users in making their own predictions.

Financial information has confirmatory value if it provides feedback about (confirms or changes) previous evaluations.

The characteristic of 'relevance' also includes the concept of materiality.

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

2. Faithful Representation

To be useful, financial information must also faithfully represent the substance of the phenomena that it purports to represent. In many circumstances, the substance of an economic phenomenon and its legal form are the same. If they are not the same, providing information only about the legal form would not faithfully represent the economic phenomenon.

To be a perfectly faithful representation, a depiction would have following three characteristics:

- **Complete:** A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.
- **Neutral:** A neutral depiction is without bias in the selection or presentation of financial information. Neutrality is supported by the exercise of prudence. Prudence is the exercise of caution when making judgements under conditions of uncertainty. The exercise of prudence means that assets and income are not overstated and liabilities and expenses are not understated.
- **Free from error:** Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. In this context, free from error does not mean perfectly accurate in all respects.

Question 6 (MTP May'24)

How can one enhance the usefulness of financial information by applying four enhancing qualitative characteristics? (4 Marks)

Solution:

The usefulness of financial information can be enhanced by applying four enhancing qualitative characteristics as follows:

- **Comparability:** Users' decisions involve choosing between alternatives. Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date. Comparability refers to the use of the same methods for the same items, and uniformity implies that like things must look alike and different things must look different.
- **Verifiability:** Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Verification can be direct or indirect.
- **Timeliness:** Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older the information is the less useful it is. However, some information may continue to be timely long after the end of a reporting period because, for example, some users may need to identify and assess trends.
- **Understandability:** Classifying, characterising and presenting information clearly and concisely makes it understandable. Some phenomena are inherently complex and cannot be made easy to understand. Financial reports 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.

EXAMPLE 1 – Capital Maintenance

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 20X2 he sold these units at ₹ 3 per unit and had withdrawn ₹ 6,000.

Average price indices at the beginning and at the end of year are 100 and 120 respectively.

Find

- Financial Capital maintenance at Historical Cost
- Financial Capital maintenance at Current Purchasing Power
- Physical Capital Maintenance (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)

Solution**i) FINANCIAL CAPITAL MAINTENANCE AT HISTORICAL COST**

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

Closing Equity = ₹ 12,000 (₹ 18,000 – ₹ 6,000)

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

	₹	₹
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

ii) FINANCIAL CAPITAL MAINTENANCE AT CURRENT PURCHASING POWER

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

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

Closing Equity at closing price = ₹ 12,000 (₹ 18,000 – ₹ 6,000)

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

	₹	₹
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)

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).

iii) PHYSICAL CAPITAL MAINTENANCE

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) × 125 = 6,000 × ₹ 2.50 = ₹ 15,000

Closing cash after adjustment of stock at current costs = ₹ 9,000 [(₹ 6,000 × 2.5) – ₹ 6,000]

Opening equity at closing current costs = ₹ 15,000

Closing equity at closing current costs = ₹ 9,000 Retained Profit = ₹ 12,000 – ₹ 15,000 = (₹ 6,000)

	₹	₹
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)

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

IND AS 1 – PRESENTATION OF FINANCIAL STATEMENTS**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.

Illustration 2

Entity XYZ is a large manufacturer of plastic products for the local market. On 1 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 ₹ 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 reported a loss of ₹ 4,000 for the year ended 31 March 20X7. At 31 March 20X7, entity XYZ's equity was ₹ 1,000. Management restructured entity B's operations in the second quarter of 20X7. That restructuring helped reduce losses for the third and fourth quarters to ₹ 400 and ₹ 380, respectively.

In January 20X7 the local plastic industry and labour union lobbied government to reinstate tariffs on plastic. On 15 March 20X7, the government announced that it would reintroduce limited plastic import tariffs 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 entity XYZ undertook a going concern assessment at 31 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 31 March 20X7 annual financial statements?

Solution

Going concern is a general feature of Presentation of 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 at least 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 31 March 20X7 financial statements**Note 1: Basis of preparation**

On the basis of management's assessment at 31st 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 15th 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 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 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 20X7-20X8. On the basis of their assessment of these factors, management believes that entity XYZ is a going concern.

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 above, 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.

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.

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 (MTP March'22)

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?

(2 Marks)

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.

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 noncurrent 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 manufacture 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 payments 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 (Past Exam May'23)

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?
- (5 Marks)**

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.

Illustration 14 – (Past Exam May'22, MTP May'24)

In December 20X1 an entity entered into a loan agreement with a bank. The loan is repayable in three equal annual instalments starting from December 20X5. One of the loan covenants is that an amount equivalent to the loan amount should be contributed by promoters by March 24 20X2, failing which the loan becomes payable on demand. As on March 24, 20X2, the entity has not been able to get the promoter's contribution. On March 25, 20X2, the entity approached the bank and obtained a grace period up to June 30, 20X2 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, 20X2.

- (a) As on March 31, 20X2, 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 20X2, the entity approached the bank and got the compliance date extended up to June 30, 20X2 for getting promoter's contribution. In this case will the loan classification as on March 31, 20X2 be different from (a) above?

(5 Marks)

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, 20X2, 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, 20X2, i.e., after the reporting date. Consequently, in the absence of actual breach of the loan covenant as on March 31, 20X2, the loan will retain its classification as non-current.

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.

Illustration 16 (MTP April'22)

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 and Paid 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 1 st 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. (10 Marks)

Solution

A Limited Consolidated 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			
(i) Trade and other receivables	3	2,100	1,735
(ii) Cash and cash equivalents	4	320	200

Total current assets		<u>4,100</u>	<u>3,715</u>
Total assets		<u>10,790</u>	<u>10,275</u>
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		<u>830</u>	<u>540</u>
Total equity		<u>4,785</u>	<u>3,940</u>
LIABILITIES			
Non-current liabilities			
(a) Financial Liabilities			
Borrowings - Long-term debt	6	2,800	3,385
(b) Provisions			
Long-term provisions (environmental restoration)		<u>765</u>	<u>640</u>
Total non-current liabilities		<u>3,565</u>	<u>4,025</u>
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) Dividend payable		150	230
(b) Provisions			
(i) Warranty provision		600	445
(ii) Other short-term provisions			
Total current liabilities		<u>35</u>	<u>25</u>
Total liabilities		<u>2,440</u>	<u>2,310</u>
Total equity and liabilities		<u>6,005</u>	<u>6,335</u>
		<u>10,790</u>	<u>10,275</u>

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.

Illustration 17 (RTP May '22) (MTP May'23)

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.

- Will the inventory and the trade receivables be current in nature?
- 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? **(4 Marks)**

Solution

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.

- 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.
- 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.

Illustration 18

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, 2XX2.

- As on March 31, 2XX2, how should the entity classify the loan?
- 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?

Solution

- 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.

Illustration 19

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 company 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.

Solution

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 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.

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 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.

Illustration 20 – (MTP – April, 2021)

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

(4 Marks)

Solution

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

Illustration 21

XYZ Limited (the Company) is into the manufacturing of tractor parts and mainly supplying components to the Original Equipment Manufacturers (OEMs). The Company does not have any subsidiary, joint venture or associate company. During the preparation of financial statements for the year ended March 31, 20X1, the accounts department is not sure about the treatment/presentation of below mentioned matters. Accounts department approached you to advice on the following matters.

S. No.	Matters
(i)	There are qualifications in the audit report of the Company with reference to two Ind AS.
(ii)	Is it mandatory to add the word -standalone before each of the components of financial statements?
(iii)	The Company is Indian Company and preparing and presenting its financial statements in ₹. Is it necessary to write in the financial statements that the financial statements has been presented in ₹.
(iv)	The Company had sales transactions with 10 related party parties during previous year. However, during current year, there are no transactions with 4 related parties out of aforesaid 10 related parties. Hence, Company is of the view that it need not disclose sales transactions with these 4 parties in related party disclosures because with these parties there are no transactions during current year.

Evaluate the above matters with respect to preparation and presentation of general purpose financial statement

Solution:

- 1) Yes, 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. (Refer Para 16 of Ind AS 1)

- ii) No, but need to disclose in the financial statement that these are individual financial statement of the Company. (Refer Para 51(b) of Ind AS 1)
- iii) Yes, Para 51(d) of Ind AS 1 inter alia states that an entity shall display the presentation currency, as defined in Ind AS 21 prominently, and repeat it when necessary for the information presented to be understandable.
- iv) No, as per Para 38 of Ind AS 1, except when Ind AS permit or require otherwise, an entity shall present comparative information in respect of the preceding period for all amounts reported in the current period's financial statements. An entity shall include comparative information for narrative and descriptive information if it is relevant to understanding the current period's financial statements.

Illustration 22

A Company presents financial results for three years (i.e one for current year and two comparative years) internally for the purpose of management information every year in addition to the general purpose financial statements. The aforesaid financial results are presented without furnishing the related notes because these are not required by the management for internal purpose. During current year, management thought why not they should present third year statement of profit and loss also in the general purpose financial statements. It will save time and will be available easily whenever management needs this in future.

With reference to above background, answer the following:

- (i) Can management present the third statement of profit and loss as additional comparative in the general purpose financial statements?
- (ii) If management present third statement of profit and loss in the general purpose financial statement as comparative, is it necessary that this statement should be compliant of Ind AS?
- (iii) Can management present third statement of profit and loss only as additional comparative in the general purpose financial statements without furnishing other components (like balance sheet, statement of cash flows, statement of change in equity) of financial statements?

Solution:

- (i) Yes, as per Para 38C of Ind AS 1, an entity may present comparative information in addition to the minimum comparative financial statements required by Ind AS, 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 paragraph 10 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.
- (ii) Yes, as per Para 38C of Ind AS 1, an entity may present comparative information in addition to the minimum comparative financial statements required by Ind AS, as long as that information is prepared in accordance with Ind AS.
- (iii) Yes, as per Para 38C of Ind AS 1, an entity may present comparative information in addition to the minimum comparative financial statements required by Ind AS, 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 paragraph 10 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.

Illustration 23

A Company while preparing the financial statements for Financial Year (FY) 20X1 -20X2, erroneously booked excess revenue of ₹ 10 Crore. The total revenue reported in FY 20X1-20X2 was ₹ 80 Crore. However, while preparing the financial statements for 20X2-20X3, it discovered that excess revenue was booked in FY 20X1 -20X2 which it now wants to correct in the financial statements. However, management of the Company is not sure whether it need to present the third balance sheet as additional comparative.

With regard to the above background, answer the following:

- (i) Is it necessary to provide the third balance sheet at the beginning of the preceding period in this case?
- (ii) The Company wants to correct the error during FY 20X2 -20X3 by giving impact in the figures of current year only. Is the contention of management correct?

Solution:

- (i) No, as per Para 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 required in paragraph 38A if:
 - (a) it applies an accounting policy retrospectively, makes a retrospective restatement of items in its financial statements or reclassifies items in its financial statements; and
 - (b) the retrospective application, retrospective restatement or the reclassification has a material effect on the information in the balance sheet at the beginning of the preceding period.
- (ii) No, management need to correct the previous year figures to correct the error but need not to furnish third balance sheet at the beginning of preceding period. (Refer Para 40A of Ind AS 1)

Illustration 24

XYZ Limited (the 'Company') is into construction of turnkey projects and has assessed its operating cycle to be 18 months. The Company has certain trade receivables and payables which are receivable and payable within a period of twelve months from the reporting date, i.e, March 31, 20X2.

In addition to above there are following items/transactions which took place during financial year 20X1-20X2.

S. No.	Items/transactions
(1)	The Company has some trade receivables which are due after 15 months from the date of balance sheet. So the Company expects that the payment will be received within the period of operating cycle.
(2)	The Company has some trade payables which are due for payment after 14 months from the date of balance sheet. These payables fall due within the period of operating cycle. Though the Company does not expect that it will be able to pay these payable within the operating cycle because the nature of business is such that generally projects gets delayed and payments from customers also gets delayed.
(3)	The Company was awarded a contract of ₹ 100 Crore on March 31, 20X2. As per the terms of the contract, the Company made a security deposit of 5% of the contract value with the customer, of ₹ 5 crore on March 31, 20X2. The contract is expected to be completed in 18 months' time. The aforesaid deposit will be refunded back after 6 months from the date of the completion of the contract.
(4)	The Company has also given certain contracts to third parties and have received security deposits from them of ₹ 2 Crore on March 31, 20X2 which are repayable on completion of the contract but if contract is cancelled before the contract term of 18 months, then it becomes payable immediately. However, the Company does not expect the cancellation of the contract.

Considering the above items/transactions answer the following:

- (i) The Company wants to present the trade receivable as current despite the fact that these are receivables in 15 months' time. Does the decision of presenting the same as current is correct?
- (ii) The Company wants to present the trade payables as non-current despite the fact that these are due within the operating cycle of the Company. Does the decision of presenting the same as non-current is correct?
- (iii) Can the security deposit of ₹ 5 Crore made by the Company with the customers be presented as current?

- (iv) Can the security deposit of ₹ 2 Crore taken by the Company from contractors be presented as non-current?

Solution:

- (i) Yes, but additionally the Company also need to disclose amounts that are receivable within a period of 12 months and after 12 months from the reporting date. (Refer Para 60 and 61 of Ind AS 1)
- (ii) No, the Company cannot disclose these payables as non-current and the Company also need to disclose amounts that are payable within a period of 12 months and after 12 months from the reporting date. (Refer Para 60 and 61 of Ind AS 1)
- (iii) No, because the amount will be received after the operating cycle of the Company. (Refer Para 66 of Ind AS 1)
- (iv) No, because the amount may be required to be paid before completion of the contract in case the contract is cancelled. (Refer Para 69 of Ind AS 1).

Illustration 25 – (RTP – Dec 2021)

Is offsetting permitted under the following circumstances?

- (a) Expenses incurred by a holding company on behalf of subsidiary, which is reimbursed by the subsidiary - whether in the separate books of the holding company, the expenditure and related reimbursement of expenses can be offset?
- (b) Whether profit on sale of an asset against loss on sale of another asset can be offset?
- (c) When services are rendered in a transaction with an entity and services are received from the same entity in two different arrangements, can the receivable and payable be offset?

Solution

- (a) As per paragraph 33 of Ind AS 1, offsetting is permitted only when the offsetting reflects the substance of the transaction.
In this case, the agreement/arrangement, if any, between the holding and subsidiary company needs to be considered. If the arrangement is to reimburse the cost incurred by the holding company on behalf of the subsidiary company, the same may be presented net. It should be ensured that the substance of the arrangement is that the payments are actually in the nature of reimbursement.
- (b) Paragraph 35 of Ind AS 1 requires an entity to present on a net basis gains and losses arising from a group of similar transactions. Accordingly, gains or losses arising on disposal of various items of property, plant and equipment shall be presented on net basis. However, gains or losses should be presented separately if they are material.
- (c) Ind AS 1 prescribes that assets and liabilities, and income and expenses should be reported separately, unless offsetting reflects the substance of the transaction. In addition to this, as per paragraph 42 of Ind AS 32, a financial asset and a financial liability should be offset if the entity has legally enforceable right to set off and the entity intends either to settle on net basis or to realise the asset and settle the liability simultaneously.

In accordance with the above, the receivable and payable should be offset against each other and net amount is presented in the balance sheet if the entity has a legal right to set off and the entity intends to do so. Otherwise, the receivable and payable should be reported separately.

MOCK TEST PAPER / REVISION TEST PAPER / PAST EXAM

Question 1 – (RTP May'21) (MTP Nov'22)

An entity has the following trial balance line items. How should these items be classified, i.e., current or non-current as per Ind AS 1?

- (a) Receivables (viz., receivable under a contract of sale of goods in which an entity deals)
- (b) Advance to suppliers
- (c) Income tax receivables [other than deferred tax]
- (d) Insurance spares

(5 Marks)**Solution:**

- (a) As per paragraph 66(a) of Ind AS 1, an entity shall classify an asset as current when it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle. Paragraph 68 provides the guidance that 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.

In accordance with above, the receivables that are considered a part of the normal operating cycle will be classified as current asset.

If the operating cycle exceeds twelve months, then additional disclosure as required by paragraph 61 of Ind AS 1 is required to be given in the notes.

- (b) As discussed in point (a) above, advances to suppliers for goods and services would be classified in accordance with normal operating cycle if it is given in relation to the goods or services in which the entity normally deals. If the advances are considered a part the normal operating cycle, it would be classified as a current asset. If the operating cycle exceeds twelve months, then additional disclosure as required by paragraph 61 of Ind AS 1 is required to be given in the notes.
- (c) Classification of income tax receivables [other than deferred tax] will be driven by paragraph 66 (c) of Ind AS 1, i.e., based on the expectation of the entity to realise the asset. If the receivable is expected to be realised within twelve months after the reporting period, then it will be classified as current asset else non-current asset.
- (d) Para 8 of Ind AS 16 states that 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.

Accordingly, the insurance spares that are treated as an item of property, plant and equipment would normally be classified as non-current asset whereas insurance spares that are treated as inventory will be classified as current asset if the entity expects to consume it in its normal operating cycle.

Question 2 – (Past Exam – Jan 2021)

Entity A had obtained a long-term bank loan during January 2019, which is subject to certain financial covenants. One of such covenants states that during the tenure of the loan, debt equity ratio of 65:35 is to be maintained at all time. In case of breach of this covenant, the loan will be repayable immediately. The loan agreement also states that these covenants will be assessed at the end of each quarter and reported to the bank within a month from the end of each quarter. If the covenants are breached at this time, the loan will be repayable immediately. The entity closes its annual accounts as on 31st March every year.

You are required to show how the loan will be classified as on 31st March 2020, if:

- (i) At the financial year end, Entity A determines that it is not in breach of any of the covenants;
- (ii) At the quarter ending 31st December 2019, Entity A's debt equity ratio became 75:25 and thus breaches the covenant, however it obtains a waiver from the bank. The terms of the waiver specify that if Entity A rectifies the breach within a period of 12 months from the reporting date then the bank cannot demand repayment immediately on account of the breach during this period. Entity A

expects to rectify the breach by raising additional equity capital by means of a rights issue to the existing shareholders and expects that the issue will be fully subscribed;

- (iii) Considering the same facts as in (ii) above, except obtaining the waiver clause, what would be your answer? **(5 Marks)**

SOLUTION

(b) Para 74 of Ind AS 1 'Presentation of Financial Statements', states 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.

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.

- (i) The entity has obtained a long-term loan during January, 2019. Since repayment period of the loan is not mentioned in the question, it is assumed that on 31st March 2020, the repayment period of the loan is more than 12 months. Further, the entity has not breached the covenants specified in the loan; therefore, as at 31st March, 2020, the loan will be classified as 'non-current liability'.
- (ii) In the second case, though there is a breach of covenant on 31st December, 2019 i.e. before reporting date of 31st March, 2020, yet the bank had agreed to provide a period of grace for twelve months from the reporting period, within which the entity A can rectify the breach and during this period bank cannot demand immediate repayment. Also, entity A has intention to rectify the breach. Thus, entity A will classify the liability of bank loan as non-current liability in its books as at 31st March, 2020.
- (iii) Since the covenant for the bank loan has been breached during the quarter ended 31st December, 2019 and reported to the bank within one month from the end of the quarter i.e. by 31st January, 2020, the bank loan becomes repayable immediately. Therefore, it will be presented as current liability in the books of entity A as on 31st March, 2020.

Question 3 (Past Exam July - 21)

Charm Limited (the 'Company') is a manufacturing company, which is into manufacturing of wires and cables and has assessed its operating cycle to be 15 months. The Company has some trade receivables which are receivable within a period of 12 months from the reporting date i.e. 31st March 2021.

With respect to the following transactions, which took place during the financial year 2020-2021, give your opinion based on relevant Ind AS:

- ✓ The Company has received a contract of ₹ 10 crore on 31st March 2021. The terms of the contract require the Company to make a security deposit of 20% of the contract value with the customer. The Company made a security deposit of ₹ 2 crore on 31st March 2021. This contract will be completed in about 14 months. 70% of the deposit will be refunded immediately and the balance 30% of the deposit will be refunded after 3 months from the completion of the contract. The Company wants to present the security deposit of ₹ 2 crore as non-current. Is the management's decision correct?
- ✓ The Company has some trade receivables that are due after 14 months from the date of the balance sheet; the management of the Company expects to receive the amount within the period of the operating cycle. Despite the fact that these are receivables in 14 months, the management would like to present these as current. Is the management's decision correct?
- ✓ In the normal course of business, the Company has given 2 contracts and received a total security deposit of ₹ 4 crore. ₹ 3 crore is received from X Limited and ₹ 1 crore is received from Y Limited on 31st March 2021. These are repayable on completion of the contract. However, if the contract is cancelled within the contract term of 18 months, then the deposit becomes payable immediately. The Company is positive about the contract with X Limited but is in doubt about the contract received from

Y Limited. The Company wants to present the amount of ₹ 3 crore as non-current and ₹ 1 crore as current in the balance sheet. Is the management's decision correct?

- ✓ The Company is planning to replace a machinery. It has given an advance of ₹ 1 crore for purchase of new machinery which will be delivered in 6 months from the date of the balance sheet. It has sold the old machinery for ₹ 0.5 crore, the payment of which is due in 10 months from the date of the balance sheet. The Company wants to present both these amounts as current since they will be settled within twelve months from the end of the reporting period. Is the management's decision correct?

(5 Marks)

Solution:

Operating cycle of Charm Limited = 15 months

- (i) The security deposit made by the Company with the customers be classified as current assets to the extent of 70% ($₹ 2 \text{ crore} \times 70\% = ₹ 1.40 \text{ crore}$) as it will be refunded immediately on completion of 14 months of contract i.e. within the operating cycle of 15 months.
However, 30% of the security deposit will be refunded after 3 months of completion of the contract ($14+3 = 17 \text{ months}$) i.e. after 2 months of operating cycle (Operating cycle of the Company is 15 months). Hence, it will be classified as non-current. Therefore, management's decision is not correct. (Refer Para 66 of Ind AS 1)
- (ii) Yes, the Company's decision of presenting the trade receivables as Current Assets is correct despite the fact that these are receivables in 14 months' time since the operating cycle of the company is 15 months and any event arising due to trade will be considered as current if its settlement is within the tenure of operating cycle. Additionally, the Company also need to disclose amounts that are receivable within a period of 12 months and after 12 months from the reporting date. (Refer Para 60 and 61 of Ind AS 1)
- (iii) Paragraph 69(d) of Ind AS 1 states that an entity shall classify a liability as current when it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period.
Although it is expected that X Limited will fulfil the contract and the deposit will not be refunded, but in case of cancellation within the contract term, refund of security deposit is a condition that is not within the control of the entity. Hence, Charm Limited does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Accordingly, the deposit will have to be classified as current liability in case of both X and Y Limited.
- (iv) Yes, the management decision to classify the payment of ₹ 0.5 crore as a current asset is correct since the payment will be realised in less than twelve months from the end of the reporting period.
Capital advances are advances given for procurement of Property, Plant and Equipment etc. Typically, companies do not expect to realize them in cash. Rather, over the period, these get converted into non-current assets. Hence, capital advances should be treated as other non-current assets irrespective of when the Property, Plant and Equipment is expected to be received.
Under Ind AS Schedule III, Capital Advances are not to be classified under Capital Work in Progress since they are specifically to be disclosed under other non-current assets.
Accordingly, advance of ₹ 1 crore given for purchase of machinery is 'Capital advance' which will be classified as non-current as it relates to acquisition of non-current item i.e., machinery. Hence, management decision to classify it as current is incorrect.

Question 4 – (MTP Oct'21)

A holding company [being the entity under consideration] gives a loan / intercorporate deposit to a subsidiary that is recoverable on demand, at a rate of interest at 10%.

- a) Should such loan be disclosed as a current/non-current asset in the books of the holding company?

How relevant would the commercial reality of the transaction be in comparison to the legal terms of the transaction?

- b) How this loan / inter-corporate deposit that is repayable on demand would be classified in the books of the subsidiary? (4 Marks)

Solution

- (a) Paragraph 66 (c) of Ind AS 1 provides that an asset shall be classified as current when an entity expects to realise the asset within a period of twelve months after the reporting period. To determine the expectation of the entity, the commercial reality of the transaction should also be considered. If the loans have been given with an understanding that these loans would not be called for repayment even though a clause may have been added that these are recoverable on demand, it should be classified as a non-current asset.
- (b) Paragraph 69(c) of Ind AS 1 provides that a liability should be classified as current if the liability is due to be settled within twelve months after the reporting period. Since the loan/inter- corporate deposit would become due immediately as and when demanded and presuming that the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period, it should be classified as current liability.

Question 5 (MTP March'22)

On 1st April, 20X3, Charming Ltd issued 1,00,000 ₹ 10 bonds for ₹ 10,00,000. On 1st April, each year, interest at the fixed rate of 8% 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? (2 Marks)

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 shall be presented as a non-current liability.

Question 6 (RTP Nov'22)

As per the statutory requirements, exceptional items are required to be disclosed whereas Ind AS 1 requires separate disclosures of material items and how these are to be presented in the financial statements. Does that imply that 'exceptional' means 'material'? Give examples. How should these be presented in the financial statements?

Solution:

Exceptional items have not been defined in Indian Accounting Standards (Ind AS). However, paragraph 97 of Ind AS 1 requires that when items of income or expense are material, an entity shall disclose their nature and amount separately.

As per Ind AS 1, 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 and it could be the determining factor.

When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

Generally, items of income or expense fulfilling the abovementioned criteria are classified as exceptional items and are disclosed separately.

From the above, it appears that all material items are not exceptional items. In other words, exceptional items are those items which meet the test of 'materiality' (size and nature) and the test of 'incidence'.

Following are some examples which may give rise to a separate disclosure of items as an 'exceptional item' in financial statements if they meet the test of 'materiality' and 'incidence':

- 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.

IND AS 2 – INVENTORIES

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.

Illustration 2

ABC Ltd. buys goods from an overseas supplier. It has recently taken delivery of 1,000 units of component X. The quoted price of component X was ₹ 1,200 per unit but ABC Ltd. has negotiated a trade discount of 5% due to the size of the order.

The supplier offers an early settlement discount of 2% for payment within 30 days and ABC Ltd. intends to achieve this.

Import duties (basic custom duties) of ₹ 60 per unit must be paid before the goods are released through custom. Once the goods are released through customs, ABC Ltd. must pay a delivery cost of ₹ 5,000 to have the components taken to its warehouse.

Calculate the cost of inventory.

Solution:

	₹
Purchase price (1,000 x 1,200 x 95%)	11,40,000
Import duties (1,000 x 60)	60,000
Delivery cost	5,000
Cost of inventory	<u>12,05,000</u>

Note: The intention to take settlement discount is irrelevant.

Illustration 3 (Normal production capacity)

A business plans for production overheads of ₹ 10,00,000 per annum. The normal level of production is 1,00,000 units per annum.

Due to supply difficulties the business was only able to make 75,000 units in the current year. Other costs per unit were ₹ 126.

Calculate the per unit cost and amount of overhead to be expensed during the year.

Solution:

Calculation of cost per unit:	₹
Other costs	126
Production overhead (10,00,000/1,00,000 units)	10
Unit cost	<u>136</u>

Overhead to be expensed:	₹

Total production overhead	10,00,000
The amount absorbed into inventory is (75,000 x 10)	<u>(7,50,000)</u>
The amount not absorbed into inventory	<u>2,50,000</u>

₹ 2,50,000 that has not been included in inventory is expensed during the year i.e. recognised in the statement of profit and loss.

Illustration 4 (Conversion costs)

ABC Ltd. manufactures control units for air conditioning systems.

Each control unit requires the following:

1 component X at a cost of ₹ 1,205 each 1 component Y at a cost of ₹ 800 each

Sundry raw materials at a cost of ₹ 150 each The company faces the following monthly expenses:

Factory rent ₹ 16,500 Energy cost ₹ 7,500

Selling and administrative costs ₹ 10,000

Each unit takes two hours to assemble. Production workers are paid ₹ 300 per hour.

Production overheads are absorbed into units of production using an hourly rate. The normal level of production per month is 1,000 hours.

Determine the cost of inventory.

Solution:

The cost of a single control unit :	₹
Materials:	
Component X	1,205
Component Y	800
Sundry raw materials	<u>150</u>
	2,155
Labour (2 hours x 300)	600
Production overhead [(16,500 + 7,500/1,000 hours) x 2 hours]	<u>48</u>
	<u>2,803</u>

Note: The selling and administrative costs are not part of the cost of inventory.

Illustration 5 – Conversion Costs

A dealer has purchased 1,000 cars costing ₹ 2,80,000 each on deferred payment basis as ₹ 25,000 per month per car to be paid in 12 equal instalments.

At year end 31 March 20X1, twenty cars are in stock. What would be the cost of goods sold, finance cost and inventory carrying amount?

Solution:

	₹
Deferred payment price (25,000 x 12)	3,00,000
Less: Cash price	<u>2,80,000</u>
Interest expense	<u>20,000</u>

		₹
Cost of inventory	20 cars x 2,80,000	56,00,000
Finance cost	1,000 cars x 20,000	2,00,00,000
Cost of goods sold	980 cars x 2,80,000	27,44,00,000

Illustration 6 – 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 7

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.

Illustration 8 (Past Exam – Dec 2021)

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 I – 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.

(5 Marks)

Solution:

As per Ind 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

Illustration 9 : 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:

- 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.
- 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:

- 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.
- 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.

Illustration 10

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.

Illustration 11

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 =	4,900
	50 @ 12 =	600
		<u>5,500</u>
Cost of Sales	12,250 - 5,500 =	6,750
Weighted average cost per item	12,250/1000 =	12.25
Weighted average inventory at	400 x 12.25 =	4,900
31.03.20X2 Cost of sales 20X1-20X2	12,250 - 4,900 =	7,350

Illustration 12 – (RTP Dec 2021)

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-in-progress 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 types 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.

Illustration 13

ABC Ltd. manufactures and sells paper envelopes. The stock of envelopes was included in the closing inventory as of 31st March, 20X1, at a cost of ₹ 50 per pack. During the final audit, the auditors noted that the subsequent sale price for the inventory at 15th April, 20X1, was ₹ 40 per pack. Furthermore, enquiry reveals that during the physical stock take, a water leakage has created damages to the paper and the

glue. Accordingly, in the following week, ABC Ltd. has spent a total of ₹ 15 per pack for repairing and reapplying glue to the envelopes.

Calculate the net realizable value and inventory write-down (loss) amount

Solution:

The net realisable value is the expected sale price ₹ 40, less cost incurred to bring the goods to its saleable condition ie ₹ 15.

Thus, NRV of envelopes pack = ₹ 40 – ₹ 15 = ₹ 25 per pack.

The loss (inventory write-down) per pack is the difference between cost and net realizable value = ₹ 50 – ₹ 25 = ₹ 25 per pack.

Illustration 14

At the end of its financial year, Company P has 100 units of inventory on hand recorded at a carrying amount of ₹ 10 per unit. The current market price is ₹ 8 per unit at which these units can be sold. Company P has a firm sales contract with Company Q to sell 60 units at ₹ 11 per unit, which cannot be settled net. Estimated incremental selling cost is ₹ 1 per unit.

Determine Net Realisable Value (NRV) of the inventory of Company P.

Solution:

While performing NRV test, the NRV of 60 units that will be sold to Company Q is ₹ 10 per unit (i.e. 11-1).

NRV of the remaining 40 units is ₹ 7 per unit (i.e. 8-1).

Therefore, Company P will write down those remaining 40 units by ₹ 120 (i.e. 40 x 3). Total cost of inventory would be

Goods to be sold to Company Q	60 units x ₹ 10	₹ 600
+ Remaining goods	40 unit x ₹ 7	₹ 280
		<u>₹ 880</u>

Illustration 15 (MTP May'23)

A business has four items of inventory. A count of the inventory has established that the amounts of inventory currently held, at cost, are as follows:

	Cost	Estimated Sales price	Selling costs
Inventory item A1	8,000	7,800	500
Inventory item A2	14,000	18,000	200
Inventory item B1	16,000	17,000	200
Inventory item C1	6,000	7,500	150

Calculate the value of closing inventory in the financial statements of a business.

(4 Marks)

Solution:

The value of closing inventory in the financial statements:

Item of inventory	Cost	NRV (Estimated Sales price- Selling costs)	Measurement base (lower of cost or NRV)	Value
A1	8,000	(7,800 – 500) 7,300	NRV	7,300
A2	14,000	(18,000 – 200) 17,800	Cost	14,000
B1	16,000	(17,000 – 200) 16,800	Cost	16,000
C1	6,000	(7,500 – 150) 7,350	Cost	6,000
Value of Inventory				43,300

Illustration 16

Particulars		Kg.	₹
Opening Inventory:	Finished Goods	1,000	25,000
	Raw Materials	1,100	11,000
Purchases		10,000	1,00,000
Labour			76,500
Overheads (Fixed)			75,000
Sales		10,000	2,80,000
Closing Inventory:	Raw Materials	900	
	Finished Goods	1200	

The expected production for the year was 15,000 kg of the finished product. Due to fall in market demand the sales price for the finished goods was ₹ 20 per kg and the replacement cost for the raw material was ₹ 9.50 per kg on the closing day. You are required to calculate the closing inventory as on that date.

Solution:

Calculation of cost for closing inventory

Particulars	₹
Cost of Purchase (10,200 x 10)	1,02,000
Direct Labour	76,500
Fixed Overhead 75,000 x 10,200 15,000	51,000
Cost of Production	2,29,500
Cost of closing inventory per unit (2,29,500/10,200)	₹ 22.50
Net Realisable Value per unit	₹ 20.00

Since net realisable value is less than cost, closing inventory will be valued at ₹ 20.

As NRV of the finished goods is less than its cost, relevant raw materials will be valued at replacement cost i.e. ₹ 9.50.

Therefore, value of closing inventory: Finished Goods (1,200 x 20) ₹ 24,000

Raw Materials (900 x 9.50) ₹ 8,550

₹ 32,550

Illustration 17

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	<u>3,200</u>	<u>2,990</u>
Total	<u>14,600</u>	<u>14,540</u>

Determine the value of Inventories:

- On an item by item basis
- 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	<u>2,990</u>
	14,290
Group basis	14,540

Illustration 18

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?

Solution:

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.).

Illustration 19 – (Past Exam – Nov 2020)

Sun Ltd. has fabricated special equipment (solar power panel) during 20 X1-20X2 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 20 X2-20X3 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.

(4 Marks)

Solution:

From the facts 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.

Illustration 20

On 31 March 20X1, the inventory of ABC includes spare parts which it had been supplying to a number of different customers for some years. The cost of the spare parts was ₹ 10 million and based on retail prices at 31 March 20X1, the expected selling price of the spare parts is ₹ 12 million. On 15 April 20X1, due to market fluctuations, expected selling price of the spare parts in stock reduced to ₹ 8 million. The estimated selling expense required to make the sales would ₹ 0.5 million. Financial statements were approved by the Board of Directors on 20th April 20X1.

As at 31st March 20X2, Directors noted that such inventory is still unsold and lying in the warehouse of the company. Directors believe that inventory is in a saleable condition and active marketing would result in an immediate sale. Since the market conditions have improved, estimated selling price of inventory is ₹ 11 million and estimated selling expenses are same ₹ 0.5 million.

What will be the value inventory at the following dates:

- (a) 31st March 20X1
- (b) 31st March 20X2

Solution:

As per Ind AS 2 'Inventories', inventory is measured at lower of 'cost' or 'net realisable value'. Further, as per Ind AS 10: 'Events after Balance Sheet Date', decline in net realisable value below cost provides additional evidence of events occurring at the balance sheet date and hence shall be considered as 'adjusting events'.

- a) In the given case, for valuation of inventory as on 31 March 20X1, cost of inventory would be ₹ 10 million and net realisable value would be ₹ 7.5 million (i.e. Expected selling price ₹ 8 million- estimated selling expenses ₹ 0.5 million). Accordingly, inventory shall be measured at ₹ 7.5 million i.e. lower of cost and net realisable value. Therefore, inventory write down of ₹ 2.5 million would be recorded in income statement of that year.
- b) As per para 33 of Ind AS 2, a new assessment is made of net realizable value in each subsequent period. It inter alia states that if there is increase in net realizable value because of changed economic circumstances, the amount of write down is reversed so that new carrying amount is the lower of the cost and the revised net realizable value. Accordingly, as at 31 March 20X2, again inventory would be valued at cost or net realisable value whichever is lower. In the present case, cost is ₹ 10 million and net realisable value would be ₹ 10.5 million (i.e. expected selling price ₹ 11 million – estimated selling expense ₹ 0.5 million). Accordingly, inventory would be recorded at ₹ 10 million and inventory write down carried out in previous year for ₹ 2.5 million shall be reversed.

Illustration 21 (RTP May 2020)

The following is relevant information for an entity:

- Full capacity is 10,000 labour hours in a year.

- Normal capacity is 7,500 labour hours in a year.
- Actual labour hours for current period are 6,500 hours.
- Total fixed production overhead is ₹ 1,500.
- Total variable production overhead is ₹ 2,600.
- Total opening inventory is 2,500 units.
- Total units produced in a year are 6,500 units.
- Total units sold in a year are 6,700 units.
- The cost of inventories is assigned by using FIFO cost formula.

How overhead costs are to be allocated to cost of goods sold and closing inventory?

Solution

Hours taken to produce 1 unit = 6,500 hours / 6,500 units = 1 hour per unit.

Fixed production overhead absorption rate:

$$\begin{aligned}
 &= \text{Fixed production overhead} / \text{labour hours for normal capacity} \\
 &= ₹ 1,500 / 7,500 \\
 &= ₹ 0.2 \text{ per hour}
 \end{aligned}$$

Management should allocate fixed overhead costs to units produced at a rate of ₹ 0.2 per hour.

Therefore, fixed production overhead allocated to 6,500 units produced during the year (one unit per hour) = 6,500 units x 1 hour x ₹ 0.2 = ₹ 1,300.

The remaining fixed overhead incurred during the year of ₹ 200 (₹ 1500 – ₹ 1300) that remains unallocated is recognised as an expense.

The amount of fixed overhead allocated to inventory is not increased as a result of low production by using normal capacity to allocate fixed overhead.

Variable production overhead absorption rate:

$$\begin{aligned}
 &= \text{Variable production overhead/actual hours for current period} \\
 &= ₹ 2,600 / 6,500 \text{ hours} = ₹ 0.4 \text{ per hour}
 \end{aligned}$$

Management should allocate variable overhead costs to units produced at a rate of ₹ 0.4 per hour.

The above rate results in the allocation of all variable overheads to units produced during the year.

Closing inventory = Opening inventory + Units produced during year – Units sold during year

$$= 2,500 + 6,500 - 6,700 = 2,300 \text{ units}$$

As each unit has taken one hour to produce (6,500 hours / 6,500 units produced), total fixed and variable production overhead recognised as part of cost of inventory:

$$\begin{aligned}
 &= \text{Number of units of closing inventory} \times \text{Number of hours to produce each unit} \times (\text{Fixed production overhead absorption rate} + \text{Variable production overhead absorption rate}) \\
 &= 2,300 \text{ units} \times 1 \text{ hour} \times (₹ 0.2 + ₹ 0.4) = ₹ 1,380
 \end{aligned}$$

The remaining ₹ 2,720 [(₹ 1,500 + ₹ 2,600) – ₹ 1,380] is recognised as an expense in the income statement as follows:

Absorbed in cost of goods sold (FIFO basis) (6,500 – 2,300) = 4,200 x ₹ 0.6	2,520
Unabsorbed fixed overheads, not included in the cost of goods sold	200
Total	<u>2,720</u>

Illustration 22

Sharp Trading Inc. purchases motorcycles from various countries and exports them to Europe. Sharp Trading has incurred these expenses during 20X1:

- (a) Cost of purchases (based on vendors' invoices) 5,00,000

- (b) Trade discounts on purchases 10,000
- (c) Import duties 200
- (d) Freight and insurance on purchases 250
- (e) Other handling costs relating to imports 100
- (f) Salaries of accounting department 15,000
- (g) Brokerage commission payable to indenting agents for arranging imports 300
- (h) Sales commission payable to sales agents 150
- (i) After-sales warranty costs 600

Advice as to which of the above items is to be included in the cost of inventory and wants you to calculate cost of inventory as per Ind AS 2.

Solution:

Items (a), (b), (c), (d), (e), and (g) are permitted to be included in the cost of inventory since these elements contribute to cost of purchase, cost of conversion and other costs incurred in bringing the inventories to their present location and condition, as per Ind AS 2

Statement showing cost of inventory

	₹
Cost of purchases (based on vendors' invoices)	5,00,000
Trade discounts on purchases	(10,000)
Import duties	200
Freight and insurance on purchases	250
Other handling costs relating to imports	100
Brokerage commission payable to indenting agents for arranging imports	300
Cost of inventory under Ind AS 2	4,90,850

Note: Salaries of accounting department, sales commission, and after-sales warranty costs are not considered as part of cost of inventory under Ind AS 2.

Illustration 23 (RTP May'21) (MTP Nov'22) (Past Exam May'23)

On 1 January 20X1 an entity accepted an order for 7,000 custom-made corporate gifts.

On 3 January 20X1, the entity purchased raw materials to be consumed in the production process for ₹ 5,50,000, including ₹ 50,000 refundable purchase taxes. The purchase price was funded by raising a loan of ₹ 5,55,000 (including ₹ 5,000 loan-raising fees). The loan is secured by the inventories.

During January 20X1 the entity designed the corporate gifts for the customer. Design costs included:

- Cost of external designer = ₹ 7,000; and
- Labour = ₹ 3,000.

During February 20X1 the entity's production team developed the manufacturing technique and made further modifications necessary to bring the inventories to the conditions specified in the agreement. The following costs were incurred in the testing phase:

- materials, net of ₹. 3,000 recovered from the sale of the scrapped output = ₹ 21,000;
- labour = ₹ 11,000; and
- depreciation of plant used to perform the modifications = ₹ 5,000.

During February 20X1 the entity incurred the following additional costs in manufacturing the customised corporate gifts:

- consumable stores = ₹ 55,000;
- labour = ₹ 65,000; and

- depreciation of plant used to manufacture the customised corporate gifts = ₹ 15,000.

The customised corporate gifts were ready for sale on 1 March 20X1. No abnormal wastage occurred in the development and manufacture of the corporate gifts.

Compute the cost of the inventory? Substantiate your answer with appropriate reasons and calculations, wherever required. (5 Marks)

SOLUTION

Statement showing computation of inventory cost

Particulars	Amount (₹)	Remarks
Costs of purchase	5,00,000	Purchase price of raw material [purchase price (₹ 5,50,000) less refundable purchase taxes (Rs. 50,000)]
Loan-raising fee	–	Included in the measurement of the liability
Costs of purchase	55,000	Purchase price of consumable stores
Costs of conversion	65,000	Direct costs—labour
Production overheads	15,000	Fixed costs—depreciation
Production overheads	10,000	Product design costs and labour cost for specific customer
Other costs	37,000	Refer working note
Borrowing costs		Recognised as an expense in profit or loss
Total cost of inventories	6,82,000	

Working Note:

Costs of testing product designed for specific customer:

₹ 21,000 material (ie net of the ₹ 3,000 recovered from the sale of the scrapped output) +
₹ 11,000 labour + ₹ 5,000 depreciation.

Question 1 – (RTP - Nov 2020)

A company normally produced 1,00,000 units of a high precision equipment each year over past several years. In the current year, due to lack of demand and competition, it produced only 50,000 units. Further information is as follows:

Material = ₹ 200 per unit; Labour = ₹ 100 per unit;

Variable manufacturing overhead = ₹ 100 per unit; Fixed factory production overhead = ₹ 1,00,00,000; Fixed factory selling overhead = ₹ 50,00,000; Variable factory selling overhead = ₹ 150 per unit.

Calculate the value of inventory per unit in accordance with Ind AS 2. What will be the treatment of fixed manufacturing overhead?

Solution:

Calculation of Inventory value per unit as per Ind AS 2:

Particulars	Value per unit (₹)
Raw material	200
Labour	100
Variable manufacturing overhead	100
Fixed production overhead (1,00,00,000/1,00,000)	100
	500

Fixed overheads are absorbed based on normally capacity level, i.e.; 1,00,000 units, rather than on the basis of actual production, i.e.; 50,000 units. Therefore, fixed manufacturing overhead on 50,000 units, will be absorbed as inventory value. The remaining fixed manufacturing overhead ₹ 50,00,000 (1,00,00,000 - 50,00,000) will be charged to P&L.

Note: Selling costs are excluded from the cost of inventories and recognised as expense in the period in which they are incurred.

Question 2 (Past Exam - May 2018)

XYZ Limited has a plant with the normal capacity to produce 10,00,000 units of a product

per annum and the expected fixed overhead is ₹ 30,00,000, Fixed overhead, therefore based on normal capacity is ₹ 3 per unit.

Determine Fixed overhead as per Ind AS 2 'Inventories' if

- (i) Actual production is 7,50,000 units.
- (ii) Actual production is 15,00,000 units.

Solution

(i) Actual production is 7,50,000 units: Fixed overhead is not going to change with the change in output and will remain constant at ₹ 30,00,000, therefore, overheads on actual basis is ₹ 4 per unit (30,00,000 / 7,50,000).

Hence, by valuing inventory at ₹ 4 each for fixed overhead purpose, it will be overvalued and the losses of ₹ 7,50,000 will also be included in closing inventory leading to a higher gross profit than actually earned.

Therefore, it is advisable to include fixed overhead per unit on normal capacity to actual production (7,50,000 × 3) ₹ 22,50,000 and balance ₹ 7,50,000 shall be transferred to Profit & Loss Account.

(ii) Actual production is 15,00,000 units: Fixed overhead is not going to change with the change in output and will remain constant at ₹ 30,00,000, therefore, overheads on actual basis is ₹ 2 (30,00,000 / 15,00,000).

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 ₹ 45,00,000

whereas, actual fixed overhead expense is only ₹ 30,00,000. Therefore, it is advisable to include fixed overhead on actual basis $(15,00,000 \times 2)$ ₹ 30,00,000.

Question 3 (MTP April'21)

State the major changes in Ind AS 2 vis-a-vis AS 2 in respect of the following namely:

- Machinery Spares
- Subsequent assessment of Net Realisable value
- Cost Formulae

(4 Marks)

Solution:

The major changes in Ind AS 2 vis-à-vis AS 2 with respect to following are as follows:

- Machinery Spares:** 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 AS 10. Ind AS 2 does not contain specific explanation in respect of such spares as this aspect is covered under Ind AS 16.
- Subsequent Assessment of Net Realisable Value (NRV):** Ind AS 2 provides detailed guidance in case of subsequent assessment of net realisable value. It also deals with the reversal of the 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. AS 2 does not deal with such reversal.
- Cost Formulae:** 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 whereas Ind AS 2 does not specifically state so and requires the use of consistent cost formulas for all inventories having a similar nature and use to the entity.

Question 4 (RTP Nov'22)

- A retailer company imported goods at a cost of ₹ 1,30,000 including ₹ 20,000 non-refundable import duties and ₹ 10,000 refundable purchase taxes. The risks and rewards of ownership of the imported goods were transferred to the retailer company upon collection of the goods from the harbour warehouse. The retailer company was required to pay for the goods upon collection. The retailer company incurred ₹ 5,000 to transport the goods to its retail outlet and a further ₹ 2,000 in delivering the goods to its customer. Further selling costs of ₹ 3,000 were incurred in selling the goods.

State whether delivery charges and selling expenses will form part of the cost of inventory. If not, then why? Also calculate the cost of inventory.

- Company A incurred ₹ 20,000 as cost for restoring the site on which the item of PPE was located. This item was used for manufacturing of goods and the requirement for restoring will arise due to manufacturing of goods.

What will the treatment of this ₹ 20,000 in the books of Company A? Analyse on the basis of the provisions of relevant Ind AS.

Solution:

i) Calculation of Inventory cost:

Particulars	Amount (₹)
Purchase Price $(1,30,000 - 20,000 - 10,000)$	1,00,000
Non-refundable import duties	20,000
Transport cost	5,000
Total	1,25,000

Note: The cost of purchase excludes the refundable purchase taxes paid on acquisition of the goods as the ₹ 10,000 paid will be refunded to the retailer.

Ind AS 2 specifically exclude selling cost from forming part of cost of inventory. However, 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. Therefore, it excludes the selling expenses incurred (i.e., ₹ 2,000 delivery costs and ₹ 3,000 other selling costs).

- ii) Paragraph 16 of Ind AS 16, Property, Plant and Equipment, inter alia states that the cost of an item of property, plant and equipment comprises 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.

Further, paragraph 18 of Ind AS 16 states that an entity applies Ind AS 2 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. The obligations for costs accounted for in accordance with Ind AS 2 or Ind AS 16 are recognised and measured in accordance with Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets.

Paragraph 16 of Ind AS 16 clarifies that decommissioning costs that meet the recognition criteria under Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets, for a provision are added to the cost of an item of property, plant and equipment if such costs are not incurred through the asset's use to produce inventories. Paragraph 18 fills the gap by clarifying where such costs are incurred through the asset's use to produce inventories, they are added to the cost of inventories.

Where the obligation to restore the asset arises due to the use of the asset to produce inventories but not due to the asset's installation, construction or acquisition, the costs are added to the costs of inventories.

Based on the above provisions and discussion, cost of restoring the site ₹ 20,000 incurred during the period of production as a consequence of having used the item to produce inventories during that period should be added to the cost of inventories. However, later the inventories are measured at the lower of cost and net realisable value in accordance with paragraph 9 of Ind AS 2.

Question 5 (RTP May 23)

An entity has following details regarding cost and retail price of the goods purchased and unsold at the beginning of the year:

	Cost	Retail Price
Opening inventory	6,250	8,000
Purchases	19,500	34,000
Inventory on hand		(23,000)
Sales for the period		19,000

Applying the retail method, compute the following:

- Percentage of cost price over retail price;
- Cost of closing inventory;
- Value of cost of sales (at cost); and
- Profit earned during the year on sale of inventory

Ignore the impact of mark-ups or mark-downs on the selling price.

Solution:

Table showing application of Retail method for calculation of the goods sold during the year and unsold inventory

S. No.	Particulars		₹
	Cost price of goods	6,250 + 19,500	25,750
	Retail price of goods	8,000 + 34,000	42,000
(a)	Cost percentage of retail price	25,750 / 42,000	61%
(b)	Closing Inventory (at cost)	23,000 x 61%	14,030
(c)	Cost of sales for the period	[(6,250 + 19,500) - 14,030]	11,720
	Sales for the period		19,000
(d)	Profit earned on sale of goods during the year	19,000 - 11,720	7,280

Question 6 (RTP Nov'23)

A Ltd. began operations in the year 20X1-20X2. In 20X1-20X2, it incurred the following expenditures on purchasing the raw materials for its product:

- Purchase price of the raw materials = ₹ 30,000;
- Import duty and other non-refundable purchase taxes = ₹ 8,000;
- Refundable purchase taxes = ₹ 1,000;
- Freight costs for bringing the goods from the supplier to the factory's storeroom for raw materials = ₹ 3,000;
- Costs of unloading the materials into the storeroom for raw materials = ₹ 20; and
- Packaging = ₹ 2,000.

On 31st March, 20X2, A Ltd. received ₹ 530 volume rebate from a supplier for purchasing more than ₹ 15,000 from the supplier during the year.

A Ltd. incurred the following additional costs in the production run:

- Salary of the machine workers in the factory = ₹ 5,000;
- Salary of factory supervisor = ₹ 3,000;
- Depreciation of the factory building and equipment used for production process = ₹ 600;
- Consumables used in the production process = ₹ 200;
- Depreciation of vehicle used to transport the goods from the storeroom for raw materials to the machine floor = ₹ 400;
- Factory electricity usage = ₹ 300;
- Factory rental = ₹ 1,000; and
- Depreciation of the entity's vehicle used by the factory supervisor is ₹ 200.

During 20X1-20X2, A Ltd. incurred the following administrative expenses:

- Depreciation of the administration building = ₹ 500;
- Depreciation and maintenance of vehicles used by the administrative staff = ₹ 150; and
- Salaries of the administrative personnel = ₹ 3,050.

Of the administrative expenses, 20% is attributable to administering the factory.

Remaining expenses are attributable, in equal proportion, to the sales and other nonproduction operations (eg financing, tax and corporate secretarial functions).

In 20X1-20X2, A Ltd. incurred the following selling expenses:

- Advertising costs = ₹ 300;

- b) Depreciation and maintenance of vehicles used by the sales staff = ₹ 100; and
 c) Salaries of the administrative personnel = ₹ 6,000.

Pass necessary journal entries to record the cost of inventory in the books of A Ltd.

Solution:

Journal Entries for the year 20X1-20X2

	₹	₹
Inventory A/c (W.N.1) Dr.	42,490	
To Cash/Bank A/c		42,490
(To recognise the cost of raw materials purchased)		
Inventory A/c (W.N.2) Dr.	11,240	
To Cash/Bank A/c (cost of direct labour)		5,000
To Property, plant and equipment (accumulated depreciation- factory equipment)		600
To Property, plant and equipment (accumulated depreciation- raw-materials delivery vehicle)		400
To Cash/Bank A/c (cost of electricity used)		300
To Property, plant and equipment (accumulated depreciation- factory supervisor's vehicle)		200
To Cash/Bank A/c (factory management's salaries)		3,000
To Cash/Bank A/c (factory rental)		1,000
To Cash/Bank A/c (administrative salaries attributable to the factory)		610
To Property, plant and equipment (attributable portion of accumulated depreciation- administration building)		100
To Property, plant and equipment (attributable portion of accumulated depreciation- administration vehicles)		30
(To recognise the costs of conversion)		
Inventory A/c (W.N.2) Dr.	200	
To Inventory A/c (consumable stores)		200
(To recognise the costs of consumable stores inventory consumed)		

The total cost of inventories = Costs of purchase + Costs of conversion
 = ₹ 42,490 + ₹ 11,240 + ₹ 200
 = ₹ 53,930

Working Notes:

1. Computation of costs of purchase

Description	₹
Purchase price	30,000
Import duty and other non-refundable purchase taxes	8,000
Freight costs for bringing the goods to the factory storeroom	3,000
Cost of unloading the raw materials into the storeroom	20
Packaging	2,000
Less: Trade discounts, rebates and subsidies	(530)

Cost of purchase	42,490

Note: Refundable taxes do not form part of the cost of inventories.

2. Computation of costs of conversion

Description	₹
Direct labour	5,000
Fixed production overheads	
Depreciation and maintenance of factory equipment	600
Depreciation of vehicle used for transporting the goods	400
Depreciation of vehicle used by factory supervisor	200
Factory electricity usage	300
Factory management	3,000
Factory rental	1,000
Other costs of administering the factory	
20% of depreciation of administration building	100
20% of depreciation of administration vehicles	30
20% of administrative staff costs	610
Variable production overheads	
Indirect material—consumables	200
Cost of conversion	11,440

Question 7 (RTP May'24)

B Limited has valued its Stock held for distribution as free items on claim by customers (on offers) at zero. Customers have a right to claim the free item within 14 days from date of invoice. If the time limit of 14-day exceeds, the claim is foregone by the customer.

The majority of the free items require online registration by the buyers for participation in the contest conducted by the respective brand which needs to be done by the buyers within 3 days from the date of invoice.

Out of it, a few items under this category were found damaged. The replacement cost of such items would be ₹ 2,50,000.

Determine whether the entity has to book loss of inventory or provide for replacement cost of the goods that need to be given as free items to customers as per the principles of Ind AS.

Solution:

Ind AS 2 deals with write-off in value of inventory. The stock of free items is valued at zero by the company. The question of "Loss of Inventory ₹ 2,50,000" does not arise as the claim of free stock is subject to various conditions like claim within 14 days, online registration within 3 days, etc. which are all contingent in nature.

However, provision is to be made for goods to be distributed in case claims from customers are received since the customer can claim the free items within 14 days from the date of invoice. Hence provision of ₹ 2,50,000 is to be made for.

IND AS 7 – STATEMENT OF CASH FLOWS

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 1 st 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 31 st January 20X1 and the redemption is due on 30 th 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 (Assumed as integral part of an entity's cash management)
8.	Treasury Bills	Include

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

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 and remaining amount paid in cash
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 and cash payment	Investing – for cash payment
14	Provident fund paid for the employees	Operating
15	Issued employee stock options	Not to be considered. No cash flow

Illustration 4 (MTP Nov'23)

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 loans and 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

(6 Marks)

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 loans and advances given	Investing
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

Illustration 5

An entity has entered into a factoring arrangement and received money from the factor. Examine the said transaction and state how should it be presented in the statement of cash flows?

Solution:**Recourse factoring:**

The cash received is classified as a financing cash inflow as the entity continues to recognize the receivables and the amount received from the factor is indeed a liability. The substance of the arrangement is financing, as the entity retains substantially all of the risk and rewards of the factored receivables.

When the cash is collected by the factor, the liability and the receivables are de-recognized. It is acceptable for this to be disclosed as a non-cash transaction, because the settlement of the liability and the factored receivables does not result in cash flows. The net impact of these transactions on the cash flow statement is to present a cash inflow from financing, but there is no operating cash flow from the original sale to the entity's customers.

Non-recourse factoring:

Where an entity de-recognises the factored receivables and receives cash from the factor, the cash receipt is classified as an operating cash inflow. This is because the entity has received cash in exchange for receivables that arose from its operating activities.

Illustration 6 (Past Exam – Dec 21)

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

Operating statement of ABC Co for the year ended 31.3.20X2

Particulars	₹
Sales	500,000.00
Less: Cost of goods sold	350,000.00
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

	20X2	20X1
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	33,000.00	35,000.00
Current Liabilities		
Trade Payables	12,000.00	8,000.00
Payables for Expenses	10,000.00	7,000.00
Total	1.15,000.00	1,00,000.00

Note: Only Indirect method was asked in exam

(4 Marks)

Solution

1. Cash flow from Operations by Direct Method

Particulars	₹	See Note
Cash Sales	497,000.00	1
Less: Cash Purchases	345,000.00	2
Overheads	52,000.00	3
Interest	-	Financing
Depreciation	-	Non cash item
Loss	-	Non cash item
Cash profit	100,000.00	
Less: Tax	<u>30,000.00</u>	
Cash profit after tax	<u>70,000.00</u>	

Note No 1 - Cash Receipts from Sales and debtors

Particulars	₹
Sales	500,000.00
Add : Opening Debtors	7,000.00
Less : Closing Debtors	<u>(10,000.00)</u>
Cash Receipts	<u>497,000.00</u>

Note No 2 :- Payment to creditors for Purchases

Particulars	₹
COGS	350,000.00

Closing stock	12,000.00
Less: Opening stock	(13,000.00)
Purchases	349,000.00
Add: Opening creditors	8,000.00
Less: Closing creditors	(12,000.00)
Payment to creditors	<u>345,000.00</u>
Note No 3 :- Payment to creditors for Expenses	
Particulars	₹
Overheads	55,000.00
Add: Opening	7,000.00
Less: Closing creditors	(10,000.00)
Payment for Overheads	<u>52,000.00</u>

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 Debtors	(3,000.00)
Increase in Creditors	4,000.00
Increase in Creditors for expenses	3,000.00
Total	<u>70,000.00</u>

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

Illustration 7

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:

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

Illustration 8

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.

Illustration 9

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.

Illustration 10

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.

Illustration 11

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 Bank	150	90
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

Illustration 12

The relevant extracts of consolidated financial statements of A Ltd. are provided below:

Consolidated Balance Sheet

	For the year ended (₹ in Lakhs)	
	31 st March 20X2	31 st March 20X1
Assets		
Non-Current Assets		
Property, Plant and Equipment	4,750	4,650
Investment in Associate	800	-
Financial Assets	2,150	1,800
Current Assets		
Inventories	1,550	1,900
Trade Receivables	1,250	1,800
Cash and Cash Equivalents	4,650	3,550
Liabilities		
Current Liabilities		

Trade Payables	1,550	3,610

Extracts from Consolidated Statement of Profit and Loss for the year ended 31st March 20X2

Particulars	Amount (₹ in Lakhs)
Revenue	12,380
Cost of Goods Sold	(9,860)
Gross Profit	2,520
Other Income	300
Operating Expenses	(450)
Other expenses	(540)
Interest expenses	(110)
Share of Profit of Associate	120
Profit before Tax	<u>1,840</u>

The below information is relevant for A Ltd Group.

1. A Ltd had spent ₹ 30 Lac on renovation of a building. A Ltd charged the entire renovation cost to profit and loss account.
2. On 1st April 20X1, A Ltd acquired 100% shares in S Ltd, for cash of ₹ 300 Lac. Fair value of the assets acquired and liabilities assumed under the acquisition are as under

Property, Plant and Equipment	140 Lac
Inventories	60 Lac
Trade Receivables	30 Lac
Cash and Cash Equivalents	<u>20 Lac</u>
Total Assets	250 Lac
Less: Trade Payables	<u>(50 Lac)</u>
Net Assets on acquisition	<u>200 Lac</u>

3. A Ltd.'s property, plant and equipment comprise the following:

Carrying amount on 1 st April 20X1	4,650 Lac
Addition (at cost) including assets in S Ltd.	800 Lac
Revaluation Surplus	80 Lac
Disposal (Sale) of Assets	(490 Lac)
Depreciation for the year	(290 Lac)
Carrying Amount on 31 st March 20X2	4,750 Lac

A Ltd constructed a machine that is a qualifying asset and incurred construction costs of ₹ 40 Lac that has been charged to other expenses. Of the interest cost of ₹ 110 Lac charged to profit or loss statement, ₹ 10 Lac includes interest cost on specific borrowings that need to be capitalized.

Property, plant and equipment was sold at 630 Lac. Gain on disposal is adjusted against operating expenses

4. A Ltd. purchased 30% interest in an Associate (G Ltd) for cash on 1st April 20X1. The associate reported profit after tax of ₹ 400 Lac and paid a dividend of ₹ 100 Lac for the year.
5. Impairment test was conducted on 31st March 20X2. The following were impaired as under:

Goodwill impairment loss: ₹ 265 Lac

Intangible Assets impairment loss ₹ 900 Lac

The goodwill impairment relates to 100% subsidiaries. Assume that interest cost is all paid in cash.

You are required to determine cash generated from operations for group reporting purposes for the year ended 31st March 20X2.

Solution:

Extracts of Statement of Cash Flows for the year ended 31 st March 20X2

Cash Flows from Operating Activities		Amount in ₹ Lacs
Profit before tax (W.N.1)		1,920
Less: Profit on Sale of PPE (630 - 490)		(140)
Add back: Depreciation		290
Impairment of Goodwill		265
Impairment of Intangible Assets		900
Less: Share of Profits of Associate (400 x 30%)		(120)
Add: Interest expense	[110 – 10]	100
Working Capital Changes (W.N.2):		
Add: Decrease in Trade Receivables		580
Add: Decrease in Inventories		410
Less: Decrease in Trade Payables		(2,110)
Cash generated from operations		2,095

Working Notes:

1. Profit before Tax

	Amount (₹ in Lakhs)
Reported profit as per Profit or Loss Statement	1,840
Add back: Renovation costs charged as expense	30
Construction costs charged as expense	40
Borrowing costs to be capitalized	10
Revised Profit before tax	1,920

2. Changes in Trade Receivables

	Amount in ₹ Lacs
Opening Balance	1,800
Add: Receivables of S Ltd.	30
	1,830
Less: Closing Balance	(1,250)
	580

3. Changes in Inventories

	Amount in ₹ Lacs
Opening Balance	1,900
Add: Receivables of S Ltd.	60
	1,960

Less: Closing Balance	(1,550)
	<u>410</u>

4. Changes in Trade Payables

	Amount in ₹ Lacs
Opening Balance	3,610
Add: Receivables of S Ltd.	<u>50</u>
	3,660
Less: Closing Balance	(1,550)
	<u>2,110</u>

Illustration 13

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	<u>3,42,000</u>	<u>3,27,500</u>
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	<u>59,000</u>	<u>60,500</u>
Total Liabilities & Equity	<u>3,42,000</u>	<u>3,27,500</u>
	20X2	
Sales	2,00,000	
Cost of Goods Sold	(1,23,000)	
Depreciation	(15,000)	
Insurance Expense	(11,000)	
Wages	<u>(50,000)</u>	
Net Profit	<u>1,000</u>	

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.

Solution

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)	
<i>Net cash flow from operating activities</i>		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	
<i>Net cash flows from financing activities</i>		14,500
<i>Net decrease in cash and cash equivalents</i>		(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	<u>15,000</u>	
	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	<u>(3,000)</u>	
<i>Net cash flow from operating activities</i>		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	<u>4,000</u>	
<i>Net cash flows from financing activities</i>		<u>14,500</u>

Net decrease in cash and cash equivalents		(10,000)
Opening Cash Balance		<u>14,000</u>
Closing Cash Balance		<u>4,000</u>

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)	<u>46,000</u>		<u>3,16,000</u>
	<u>3,16,000</u>		

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)	<u>1,24,000</u>		<u>1,60,000</u>
	<u>1,60,000</u>		

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
	<u>18,000</u>		<u>18,000</u>

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
	<u>88,000</u>		<u>88,000</u>

Illustration 14

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
	<u>3,250</u>		<u>3,250</u>

Solution

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

Illustration 15

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?

Solution

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.

Illustration 16 - (RTP - MAY 2018)

Company A acquires 70% of the equity stake in Company B on July 20, 20X1. The consideration paid for this transaction is as below:

- (a) Cash consideration of ₹ 15,00,000
- (b) 200,000 equity shares having face of ₹ 10 and fair value of ₹ 15 per share.

On the date of acquisition, Company B has cash and cash equivalent balance of ₹2,50,000 in its books of account.

On October 10, 20X2, Company A further acquires 10% stake in Company B for cash consideration of ₹ 8,00,000.

Advise how the above transactions will be disclosed/presented in statement of cash flows as per Ind AS 7.

Solution

As per para 39 of Ind AS 7, the aggregate cash flows arising from obtaining control of subsidiary shall be presented separately and classified as investing activities.

As per para 42 of Ind AS 7, the aggregate amount of the cash paid or received as consideration for obtaining subsidiaries is reported in the statement of cash flows net of cash and cash equivalents acquired or disposed of as part of such transactions, even ts or changes in circumstances.

Further, 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.

As per para 42A of Ind AS 7, 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, as defined in Ind AS 110, and is required to be measured at fair value through profit or loss. Such transactions are accounted for as equity transactions and accordingly, the resulting cash flows are classified in the same way as other transactions with owners.

Considering the above, for the financial year ended March 31, 20 X2 total consideration of ₹15,00,000 less ₹ 250,000 will be shown under investing activities as "Acquisition of the subsidiary (net of cash acquired)".

There will not be any impact of issuance of equity shares as consideration in the cash flow statement however a proper disclosure shall be given elsewhere in the financial statements in a way that provides all the relevant information about the issuance of equity shares for non-cash consideration.

Further, in the statement of cash flows for the year ended March 31, 20 X3, cash consideration paid for the acquisition of additional 10% stake in Company B will be shown under financing activities.

Illustration 17 - (RTP May'20) (MTP May'20) (Past Exam Nov'20)

Entity A acquired a subsidiary, Entity B, during the year. Summarised information from the Consolidated Statement of Profit and Loss and Balance Sheet is provided, together with some supplementary information.

Consolidated Statement of Profit and Loss	Amount (₹)
Revenue	3,80,000
Cost of sales	(2,20,000)
Gross profit	1,60,000
Depreciation	(30,000)
Other operating expenses	(56,000)
Interest cost	(4,000)
Profit before taxation	70,000
Taxation	(15,000)
Profit after taxation	55,000

Consolidated balance sheet	20X2	20X1
Assets	Amount	Amount
	(₹)	(₹)
Cash and cash equivalents	8,000	5,000
Trade receivables	54,000	50,000
Inventories	30,000	35,000
Property, plant and equipment	1,60,000	80,000
Goodwill	18,000	—
Total assets	2,70,000	1,70,000
Liabilities		
Trade payables	68,000	60,000
Income tax payable	12,000	11,000
Long term debt	1,00,000	64,000
Total liabilities	1,80,000	1,35,000
Shareholders' equity	90,000	35,000
Total liabilities and shareholders'	2,70,000	1,70,000

Other information

All of the shares of entity B were acquired for ₹ 74,000 in cash. The fair values of assets acquired and liabilities assumed were:

Particulars	Amount (₹)
Inventories	4,000
Trade receivables	8,000
Cash	2,000

Property, plant and equipment	1,10,000
Trade payables	(32,000)
Long term debt	(36,000)
Goodwill	<u>18,000</u>
Cash consideration paid	<u>74,000</u>

Prepare the Consolidated Statement of Cash Flows for the year 20X2, as per Ind AS 7.

(8 Marks)

Solution

This information will be incorporated into the Consolidated Statement of Cash Flows as follows:

Statement of Cash Flows for the year ended 20X2 (extract)

	Amount (₹)	Amount (₹)
Cash flows from operating activities		
Profit before taxation	70,000	
Adjustments for non-cash items:		
Depreciation	30,000	
Decrease in inventories (W.N. 1)	9,000	
Decrease in trade receivables (W.N. 2)	4,000	
Decrease in trade payables (W.N. 3)	(24,000)	
Interest paid to be included in financing activities	4,000	
Taxation (11,000 + 15,000 – 12,000)	<u>(14,000)</u>	
Net cash generated from operating activities		79,000
Cash flows from Investing activities		
Cash paid to acquire subsidiary (74,000 – 2,000)	<u>(72,000)</u>	
Net cash outflow from investing activities		(72,000)
Cash flows from financing activities		
Interest paid	<u>(4,000)</u>	
Net cash outflow from financing activities		<u>(4,000)</u>
Increase in cash and cash equivalents during the year		3,000
Cash and cash equivalents at the beginning of the year		<u>5,000</u>
Cash and cash equivalents at the end of the year		<u>8,000</u>

Working Notes:

1.	Calculation of change in Inventory during the year	₹
	Total inventories of the Group at the end of the year	30,000
	Inventories acquired during the year from subsidiary	<u>(4,000)</u>
		26,000
	Opening Inventories	<u>35,000</u>
	Decrease in Inventories	<u>9,000</u>

2.	Calculation of change in Trade Receivables during the year	₹
	Total trade receivables of the Group at the end of the year	54,000

Trade receivables acquired during the year from subsidiary	(8,000)
	46,000
Opening trade receivables	50,000
Decrease in trade receivables	4,000

3. Calculation of change in Trade Payables during the year	₹
Trade payables at the end of the year	68,000
Trade payables of the subsidiary assumed during the year	(32,000)
	36,000
Opening trade payables	60,000
Decrease in trade payables	24,000

Illustration 18 - (RTP Nov'20) (MTP Mar'21, May'23)

During the financial year 2019-2020, Akola Limited have paid various taxes & reproduced the below mentioned records for your perusal:

- Capital gain tax of ₹ 20 crore on sale of office premises at a sale consideration of 100 crore.
- Income Tax of ₹ 3 crore on Business profits amounting ₹ 30 crore (assume entire business profit as cash profit).
- Dividend Distribution Tax of ₹ 2 crore on payment of dividend amounting ₹ 20 crore to its shareholders.
- Income tax Refund of ₹ 1.5 crore (Refund on taxes paid in earlier periods for business profits).

You need to determine the net cash flow from operating activities, investing activities and financing activities of Akola Limited as per relevant Ind AS. **(5 Marks)**

Solution

Para 36 of Ind AS 7 inter alia states that 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. When tax cash flows are allocated over more than one class of activity, the total amount of taxes paid is disclosed.

Accordingly, the transactions are analysed as follows:

Particulars	Amount (in crore)	Activity
Sale Consideration	100	Investing Activity
Capital Gain Tax	(20)	Investing Activity
Business profits	30	Operating Activity
Tax on Business profits	(3)	Operating Activity
Dividend Payment	(20)	Financing Activity
Dividend Distribution Tax	(2)	Financing Activity
Income Tax Refund	1.5	Operating Activity
Total Cash flow	86.5	

Activity wise	Amount (in crore)
Operating Activity	28.5
Investing Activity	80
Financing Activity	(22)
Total	86.5

Illustration 19 - (RTP Dec'21), (MTP Nov'22)

From the following data of Galaxy Ltd., prepare statement of cash flows showing cash generated from Operating Activities using direct method as per Ind AS 7:

	31.3.20X2 (₹)	31.3.20X1 (₹)
Current Assets:		
Inventory	1,20,000	1,65,000
Trade receivables	2,05,000	1,88,000
Cash & cash equivalents	35,000	20,500
Current Liabilities:		
Trade payable	1,95,000	2,15,000
Provision for tax	48,000	65,000

Summary of Statement of Profit and Loss		₹
Sales	85,50,000	
Less: Cost of sales	(56,00,000)	29,50,000
Other Income		
Interest income	20,000	
Fire insurance claim received	1,10,000	1,30,000
		30,80,000
Depreciation	(24,000)	
Administrative and selling expenses	(15,40,000)	
Interest expenses	(36,000)	
Foreign exchange loss	(18,000)	(16,18,000)
Net Profit before tax and extraordinary income		14,62,000
Income Tax		(95,000)
Net Profit		13,67,000

Additional information:

- Trade receivables and Trade payables include amounts relating to credit sale and credit purchase only.
- Foreign exchange loss represents increment in liability of a long-term borrowing due to exchange rate fluctuation between acquisition date and balance sheet date.

(8 Marks)**SOLUTION**

Statement Cash Flows from operating activities
of Galaxy Ltd. for the year ended 31 March 20X2 (Direct Method)

Particulars	₹	₹
Operating Activities:		
Cash received from Trade receivables (W.N. 3)		85,33,000
Less: Cash paid to Suppliers (W.N.2)	55,75,000	
Payment for Administration and Selling expenses	15,40,000	
Payment for Income Tax (W.N.4)	1,12,000	(72,27,000)
		13,06,000
Adjustment for exceptional items (fire insurance		1,10,000

claim)		
Net cash generated from operating activities		14,16,000

Working Notes:**(1) Calculation of total purchases**

Cost of Sales = Opening stock + Purchases – Closing Stock

₹ 56,00,000 = ₹ 1,65,000 + Purchases – ₹ 1,20,000

Purchases = ₹ 55,55,000

(2) Calculation of cash paid to Suppliers**Trade Payables**

		₹			₹
To	Bank A/c (balancing figure)	55,75,000	By	Balance b/d	2,15,000
To	Balance c/d	<u>1,95,000</u>	By	Purchases (W.N. 1)	<u>55,55,000</u>
		<u>57,70,000</u>			<u>57,70,000</u>

(3) Calculation of cash received from Customers**Trade Receivables**

		₹			₹
To	Balance b/d	1,88,000	By	Bank A/c (balancing figure)	85,33,000
To	Sales	<u>85,50,000</u>	By	Balance c/d	<u>2,05,000</u>
		<u>87,38,000</u>			<u>87,38,000</u>

(4) Calculation of tax paid during the year in cash**Provision for tax**

		₹			₹
To	Bank A/c (balancing figure)	1,12,000	By	Balance b/d	65,000
To	Balance c/d	<u>48,000</u>	By	Profit and Loss A/c	<u>95,000</u>
		<u>1,60,000</u>			<u>1,60,000</u>

Question 1 - (MTP OCT'19)

A Ltd., whose functional currency is Indian Rupee, had a balance of cash and cash equivalents of Rs. 2,00,000, but there are no trade receivables or trade payables balances as on 1st April, 20X1. During the year 20X1-20X2, the entity entered into the following foreign currency transactions:

- A Ltd. purchased goods for resale from Europe for €2,00,000 when the exchange rate was €1 = Rs. 50. This balance is still unpaid at 31st March, 20X2 when the exchange rate is €1 = Rs. 45. An exchange gain on retranslation of the trade payable of Rs. 5,00,000 is recorded in profit or loss.
- A Ltd. sold the goods to an American client for \$ 1,50,000 when the exchange rate was \$1 = Rs. 40. This amount was settled when the exchange rate was \$1 = Rs. 42. A further exchange gain regarding the trade receivable is recorded in the statement of profit or loss.
- A Ltd. also borrowed €1,00,000 under a long-term loan agreement when the exchange rate was €1 = Rs. 50 and immediately converted it to Rs. 50,00,000. The loan was retranslated at 31st March, 20X2 @ Rs. 45, with a further exchange gain recorded in the statement of profit or loss.
- A Ltd. therefore records a cumulative exchange gain of Rs. 18,00,000 (10,00,000 + 3,00,000 + 5,00,000) in arriving at its profit for the year.
- In addition, A Ltd. records a gross profit of Rs. 10,00,000 (Rs. 60,00,000 – Rs. 50,00,000) on the sale of the goods.

Ignore taxation.

How cash flows arising from the above transactions would be reported in the statement of cash flows of A Ltd. under indirect method?

SOLUTION:

ICAI Solution (Which is incorrect)

Statement of cash flows

Particulars		Amount (Rs.)
Cash flows from operating activities		
Profit before taxation (10,00,000 + 18,00,000)	28,00,000	
Adjustment for unrealised exchange gains/losses:		
Foreign exchange gain on long term loan [€ 2,00,000 x Rs. (50 – 45)]	(10,00,000)	
Decrease in trade payables [1,00,000 x Rs. (50 – 45)]	<u>(5,00,000)</u>	
Operating Cash flow before working capital changes	13,00,000	
Changes in working capital (Due to increase in trade payables)	<u>50,00,000</u>	
Net cash inflow from operating activities		63,00,000
Cash inflow from financing activity		<u>50,00,000</u>
Net increase in cash and cash equivalents		1,13,00,000
Cash and cash equivalents at the beginning of the period		<u>2,00,000</u>
Cash and cash equivalents at the end of the period		<u>1,15,00,000</u>

Rectified Solution (By AK)**Statement of cash flows**

Particulars		Amount (Rs.)
Cash flows from operating activities		
Profit before taxation (10,00,000 + 18,00,000)	28,00,000	
Adjustment for unrealised exchange gains/losses:		
Foreign exchange gain on long term loan (€ 1,00,000 x Rs. (50 - 45))	(5,00,000)	
Decrease in trade payables (€ 2,00,000 x Rs. (50 - 45))	(10,00,000)	
Operating Cash flow before working capital changes	13,00,000	
Changes in working capital (Due to increase in trade payables)	50,00,000	
Net cash inflow from operating activities		63,00,000
Cash inflow from financing activity		50,00,000
Net increase in cash and cash equivalents		1,13,00,000
Cash and cash equivalents at the beginning of the period		2,00,000
Cash and cash equivalents at the end of the period		1,15,00,000

Question 2 - (RTP – May 2021)

From the following data, identify the nature of activities as per Ind AS 7.

S.no.	Nature of transaction
1	Cash paid to employees
2	Cash paid for development of property costs
3	Borrowings repaid
4	Cash paid to suppliers
5	Loan to Director
6	Bonus shares issued
7	Dividends paid
8	Cash received from trade receivables
9	Proceeds from sale of PPE
10	Depreciation of PPE
11	Advance received from customers
12	Purchased goodwill
13	Payment of promissory notes

Solution:

Sr. No.	Nature of transaction	Activity as per Ind AS 7
1	Cash paid to employees	Operating activity
2	Cash paid for development costs	Investing activity
3	Borrowings repaid	Financing activity
4	Cash paid to suppliers	Operating activity

5	Loan to Director	Investing activity
6	Bonus shares issued	Non-cash item
7	Dividends paid	Financing activity
8	Cash received from trade receivables	Operating activity
9	Proceeds from sale of PPE	Investing activity
10	Depreciation of PPE	Non-cash item
11	Advance received from customers	Operating activity
12	Purchased goodwill	Investing activity
13	Payment of promissory notes	Financing activity

Question 3 - (Past Exam – Jan 2021)

Z Ltd. (India) has an overseas branch in USA. It has a bank account having balance of USD 7,000 as on 1st April 2019. During the financial year 2019-2020, Z Ltd. acquired computers for its USA office for USD 280 which was paid on same date. There is no other transaction reported in USA or India. Exchange rates between INR and USD during the financial year 2019-2020 were:

Date	USD 1 to INR
1st April 2019	70.00
30th November 2019	71.00 (Date of purchase of computer)
31st March 2020	71.50
Average for 2019-2020	70.50

Please prepare the extract of Cash Flow Statement for the year ended 31 st March 2020 as per the relevant Ind AS and also show the foreign exchange profitability from these transactions for the financial year 2019-2020? **(5 Marks)**

SOLUTION

In the books of Z Ltd.

Statement of Cash Flows for the year ended 31st March 2020

	₹	₹
<u>Cash flows from operating activities</u>		
Net Profit (Refer Working Note)	10,360	
Adjustments for non-cash items:		
Foreign Exchange Gain	(10,360)	
Net cash outflow from operating activities		0
<u>Cash flows from investing activities</u>		
Acquisition of Property, Plant and Equipment	(19,880)	
Net cash outflow from Investing activities		(19,880)
<u>Cash flows from financing activities</u>		0
Net change in cash and cash equivalents		(19,880)
Cash and cash equivalents at the beginning of the year i.e. 1st April 2019		4,90,000
Foreign Exchange difference		10,360
Cash and cash equivalents at the end of the year i.e. 31st March 2020		4,80,480

Working Note:**Computation of Foreign Exchange Gain**

Bank Account USD	Date	USD	Exchange Rate	₹
Opening balance	1.4.2019	7,000	70.00	4,90,000
Less: Purchase of Computer	30.11.2019	280	71.00	19,880
Closing balance calculated		6,720		4,70,120
Closing balance (at year end spot rate)	31.3.2020	6,720	71.50	4,80,480
Foreign Exchange Gain credited to				
Profit and Loss account				10,360

Question 4 – (Past Exam – Dec 2021)

In the year 2020-2021, one land was sold for ₹ 5 crore and another land purchased for ₹ 3 crore by XYZ Limited. Company reported Cash Flow on a Net Basis in Cash Flow Statement i.e. ₹ 2 crore in Investing Activity as Cash receipt from Sale of Land. Advise whether treatment given as above is correct or not as per the provisions of Ind AS 7. (2 Marks)

Solution:**Correct treatment of cash flow:**

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.

Accordingly, in the year 2020-2021, while presenting the information, entity will show separately cash outflow from investing activity of ₹ 3 crore for purchase of land and cash inflow from investing activity of ₹ 5 crore from sale of land.

Question 5 (RTP Nov'22)

What will be the classification for following items in the statement of cash flows of both:

(i) Banks / Financial institutions and (ii) Other Entities?

S. No.	Particulars
1.	Interest received on loans and advances given
2.	Interest paid on deposits and other borrowings
3.	Interest and dividend received on investments in subsidiaries, associates and in other entities
4.	Dividend paid on preference and equity shares, including tax on dividend paid on preference and equity shares by other entities
5.	Finance charges paid by lessee under finance lease
6.	Payment towards reduction of outstanding finance lease liability
7.	Interest paid to vendor for acquiring fixed asset under deferred payment basis
8.	Principal sum payment under deferred payment basis for acquisition of fixed assets
9.	Penal interest received from customers for late payments
10.	Penal interest paid to suppliers for late payments
11.	Interest paid on delayed tax payments
12.	Interest received on tax refunds

Solution:

The following are the classification of various activities in the Statement of Cash Flows:

S. No.	Particulars	Classification for reporting cash flows	
		Banks / financial institutions	Other entities
1.	Interest received on loans and advances given	Operating Activities	Investing activities
2.	Interest paid on deposits and other borrowings	Operating Activities	Financing activities
3.	Interest and dividend received on investments in subsidiaries, associates and in other entities	Investing activities	Investing activities
4.	Dividend paid on preference and equity shares, including tax on dividend paid on preference and equity shares by other entities	Financing activities	Financing activities
5.	Finance charges, paid by lessee under finance lease	Financing activities	Financing activities
6.	Payment towards reduction of outstanding finance lease liability	Financing activities	Financing activities
7.	Interest paid to vendor for acquiring fixed asset under deferred payment basis	Financing activities	Financing activities
8.	Principal sum payment under deferred payment basis for acquisition of fixed assets	Investing activities	Investing activities
9.	Penal interest received from customers for late payments	Operating Activities	Operating Activities
10.	Penal interest paid to suppliers for late payments	Operating Activities	Operating Activities
11.	Interest paid on delayed tax payments	Operating Activities	Operating Activities
12.	Interest received on tax refunds	Operating Activities	Operating Activities

Question 6 (RTP Nov 23)

One of the subsidiaries of Buildwell Ltd. submitted to Central Finance its Summarized Statement of Profit and Loss and Balance Sheet.

Summarized Statement of Profit and Loss for the year ended 31st March, 20X3

Particulars	Amount (₹)
Net sales	2,52,00,000
Less: Cash cost of sales	(1,92,00,000)
Depreciation	(6,00,000)
Salaries & wages	(24,00,000)
Operating expenses	(14,00,000)
Provision for taxation	(8,80,000)
Net Operating Profit	7,20,000
Non-recurring income – profit on sale of equipment	1,20,000
	8,40,000
Retained earnings and profit brought forward	15,18,000
	23,58,000
Dividends declared and paid during the year	(7,20,000)
Profit & loss balance as on 31st March, 20X3	16,38,000

Summarized Balance Sheet

Assets	31st March, 20X2	31st March, 20X3
Property, Plant and Equipment:		
Land	4,80,000	9,60,000
Buildings and Equipment	36,00,000	57,60,000
Current Assets		
Cash	6,00,000	7,20,000
Inventories	16,80,000	18,60,000
Trade Receivables	26,40,000	9,60,000
Advances	<u>78,000</u>	<u>90,000</u>
Total Assets	<u>90,78,000</u>	<u>1,03,50,000</u>

Liabilities & Equity		
Share capital	36,00,000	44,40,000
Surplus in profit & loss	15,18,000	16,38,000
Trade Payables	24,00,000	23,40,000
Outstanding expenses	2,40,000	4,80,000
Income tax payable	1,20,000	1,32,000
Accumulated depreciation on buildings and equipment	<u>12,00,000</u>	<u>13,20,000</u>
Total	<u>90,78,000</u>	<u>1,03,50,000</u>

The original cost of equipment sold during the year 20X2-20X3 was ₹ 7,20,000.

Prepare a statement of cashflows the year ended 31st March 20X3.

Solution:

Statement of Cash Flows for the year ended 31st March, 20X3 (Indirect method)

Particulars	₹	₹
Cash flow from operating activities:		
Net Profit before taxes and extraordinary items (7,20,000 + 8,80,000)	16,00,000	
Add: Depreciation	<u>6,00,000</u>	
Operating profit before working capital changes	22,00,000	
Increase in inventories	(1,80,000)	
Decrease in trade receivables	16,80,000	
Advances	(12,000)	
Decrease in trade payables	(60,000)	
Increase in outstanding expenses	<u>2,40,000</u>	
Cash generated from operations	38,68,000	
Less: Income tax paid (Refer W.N.4)	<u>(8,68,000)</u>	
Net cash from operations		30,00,000
Cash from investing activities:		
Purchase of land	(4,80,000)	

Purchase of building & equipment (Refer W.N.2)	(28,80,000)	
Sale of equipment (Refer W.N.3)	<u>3,60,000</u>	
Net cash used for investment activities		(30,00,000)
Cash flows from financing activities:		
Issue of share capital	8,40,000	
Dividends paid	<u>(7,20,000)</u>	
Net cash from financing activities:		1,20,000
Net increase in cash and cash equivalents		1,20,000
Cash and cash equivalents at the beginning		<u>6,00,000</u>
Cash and cash equivalents at the end		<u>7,20,000</u>

Working Notes:**1. Building & Equipment Account**

Particulars	₹	Particulars	₹
To Balance b/d	36,00,000	By Sale of assets	7,20,000
To Cash / bank (purchases)(bal. fig)	28,80,000	By Balance c/d	57,60,000
	64,80,000		64,80,000

2. Building & Equipment Accumulated Depreciation Account

Particulars	₹	Particulars	₹
To Sale of asset (acc. depreciation)	4,80,000	By Balance b/d	12,00,000
To Balance c/d	13,20,000	By Profit & Loss A/c (provisional)	6,00,000
	18,00,000		18,00,000

3. Computation of sale price of Equipment

Particulars	₹
Original cost	7,20,000
Less: Accumulated Depreciation	(4,80,000)
Net cost	2,40,000
Profit on sale of assets	1,20,000
Sale proceeds from sale of assets	3,60,000

4. Provision for tax Account

Particulars	₹	Particulars	₹
To Bank A/c	8,68,000	By Balance b/d	1,20,000
To Balance c/d	1,32,000	By Profit & Loss A/c (provisional)	8,80,000
	10,00,000		10,00,000

Question 7 (RTP May'24)

Following is the Balance Sheet of Mars Ltd:

₹ In Lakhs

Particulars	31.3.20X3	31.3.20X2
ASSETS		
Non-Current Assets		
Property, Plant and Equipment	450	410
Intangible asset	90	90
Deferred Tax Asset (net)	45	45
Other Non-current Asset	95	85
Total Non-current Assets	680	630
Current Assets		
Financial Asset		
Investments	100	60
Trade Receivables	580	600
Cash and Cash Equivalents	300	300
Inventories	800	700
Other Current Assets	160	120
Total Current Assets	1,940	1,780
Total Assets	2,620	2,410
Equity and Liabilities		
Equity		
Equity Share Capital	280	250
Other Equity	980	820
Total Equity	1,260	1,070
Non-current Liabilities		
Financial Liabilities		
Borrowings	360	300
Other Non-current Liabilities	90	80
Total Non-current Liabilities	450	380
Current Liabilities		
Financial Liabilities		
Trade Payable	455	450
Bank Overdraft	410	420
Other current liabilities	45	90
Total Current Liabilities	910	960
Total Liabilities	1,360	1,340
Total Equity and Liabilities	2,620	2,410

Additional Information:

- Profit before tax for the year is ₹ 200 lakhs and provision for tax is ₹ 40 lakhs.
- Property, Plant and Equipment purchased during the year ₹ 100 lakhs.
- Current liabilities include Capital creditors of ₹ 25 lakhs as at 31st March 20X3 (Nil – 31st March 20X2)
- Long Term Borrowings raised during the year ₹ 120 lakhs.

From the information given, prepare a Statement of Cash Flows following Indirect Method. Assume that Bank overdraft is an integral part of the entity's cash management.

Solution:

Statement of Cash Flows for the year ended 31st March, 20X3

	(₹ In lakhs)	(₹ In lakhs)
Cash flows from operating activities		
Profit before taxation	200	
Adjustments for non-cash items:		
Depreciation [410 - (450 - 100)]	60	
	260	
Increase in inventories (800 - 700)	(100)	
Decrease in trade receivables (600 - 580)	20	
Increase in other non-current assets (95 - 85)	(10)	
Increase in other current assets (160 - 120)	(40)	
Increase in non-current liabilities (90 - 80)	10	
Increase in trade payables (455 - 25 - 450)	(20)	
Other current liabilities (Refer Note 1)		
[(90 + 40) - 45]	(85)	
Net cash generated from operating activities		35
Cash flows from investing activities		
Cash paid to purchase PPE (100-25)	(75)	
Cash paid to acquire investment (100-60)	(40)	
Net cash outflow from investing activities		(115)
Cash flows from financing activities		
Raising of equity share capital (280 - 250)	30	
Long-term borrowings raised during the year	120	
Long-term borrowings repaid during the year		
[(300 + 120) - 360]	(60)	
Net cash outflow from financing activities		90
Increase in cash and cash equivalents during the year		10
Cash and cash equivalents at the beginning of the year (420-300) (Refer Note 2)		(120)
Cash and cash equivalents at the end of the year (410-300) (Refer Note 2)		(110)

Note:

1. Other current liabilities are assumed to consist of provision for taxation.
2. ICAI has assumed other current and other non current to be operating in nature hence the same has been considered in operating activities.

IND AS 8 – ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

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."

Illustration 2 – (Past Exam Dec'21) (MTP May'24)

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? (5 Marks)

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

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.

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)

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.

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, 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

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.

Illustration 8 (RTP May'20)

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 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 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.

Illustration 9

A carpet retail outlet sells and fits carpets to the general public. It recognizes revenue when the carpet is fitted, which on an average is six weeks after the purchase of the carpet.

It then decides to sub-contract the fitting of carpets to self-employed fitters. It now recognizes revenue at the point-of-sale of the carpet.

Whether this change in recognising the revenue is a change in accounting policy as per the provision of Ind AS 8?

Solution:

This is not a change in accounting policy as the carpet retailer has changed the way that the carpets are fitted.

Therefore, there would be no need to retrospectively change prior period figures for revenue recognized.

Illustration 10

When is an entity required to present a third balance sheet as at the beginning of the preceding period?

Solution:

As per paragraph 40A of Ind AS 1, Presentation of Financial Statements, an entity shall present a third balance sheet as at the beginning of the preceding period in addition to the minimum comparative financial statements required by paragraph 38A of the standard if:

- it applies an accounting policy retrospectively, makes a retrospective restatement of items in its financial statements or reclassifies items in its financial statements; and

- the retrospective application, retrospective restatement or the reclassification has a material effect on the information in the balance sheet at the beginning of the preceding period

Illustration 11

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:

1. Delta Ltd.'s tax rate	30%
2. Property, plant and equipment at the end of 20X1:	
Cost	₹ 25,000
Depreciation	₹ 14,000
Net book Value	₹ 11,000
3. Prospective depreciation expense for 20X2 (old basis)	₹ 1,500
4. 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.

Solution:

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.

Illustration 12

Is change in the depreciation method for an item of property, plant and equipment a change in

accounting policy or a change in accounting estimate?

Solution:

As Paragraphs 60 and 61 of Ind AS 16, Property, Plant and Equipment, 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 shall be 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 shall 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.

As per the above, depreciation method for a depreciable asset has to reflect the expected pattern of consumption of future economic benefits embodied in the asset. Determination of depreciation method involves an accounting estimate and thus depreciation method is not a matter of an accounting policy.

Accordingly, Ind AS 16 requires a change in depreciation method to be accounted for as a change in an accounting estimate, i.e., prospectively.

Illustration 13 – (MTP April'21) (RTP May'20)

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 will be considered as correction of an error under Ind AS 8? Would the entity need to present a third balance sheet? (5 Marks)

Solution

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.

Illustration 14 – (Past Exam Nov'22)

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?

(5 Marks)

Solution:

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.

Illustration 15 (RTP Dec'21, Nov'22)

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?

Solution:

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.

Illustration 16

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. 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. 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? For simplicity, ignore tax effects.

Solution:

The error shall be corrected by retrospectively restating the figures for financial year 20X2-20X3 and also by presenting a third balance sheet as at April 1, 20X2 which is the beginning of the earliest period presented in the financial statements

Illustration 17

ABC Ltd. changed its method adopted for inventory valuation in the year 20 X2-20X3. Prior to the change, inventory was valued using the first in first out method (FIFO). However, it was felt that in order to match current practice and to make the financial statements more relevant and reliable, a weighted average valuation model would be more appropriate.

The effect of the change in the method of valuation of inventory was as follows:

- 31st March, 20X1 - Increase of ₹ 10 million
- 31st March, 20X2 - Increase of ₹ 15 million
- 31st March, 20X3 - Increase of ₹ 20 million

Profit or loss under the FIFO valuation model are as follows:

	20X2-20X3	20X1-20X2
Revenue	324	296
Cost of goods sold	(173)	(164)
Gross profit	151	132
Expenses	(83)	(74)
Profit	68	58

Retained earnings at 31st March, 20X1 were ₹ 423 million

Present the change in accounting policy in the profit or loss and produce an extract of the statement of changes in equity in accordance with Ind AS 8

Solution:

Profit or loss under weighted average valuation method is as follows:

	20X2-20X3	20X1-20X2 (Restated)
Revenue	324	296
Cost of goods sold	(168)	(159)
Gross profit	156	137
Expenses	(83)	(74)
Profit	73	63

Statement of changes in Equity (extract)

	Retained earnings	Retained earnings (Original)
At 1 st April, 20X1	423	423
Change in inventory valuation policy	10	-
At 1st April, 20X1 (Restated)	433	-
Profit for the year 20X1-20X2	63	58
At 31st March, 20X2	496	481
Profit for the 20X2-20X3	73	68
At 31st March, 20X3	569	549

Illustration 18 - (RTP Nov'19) (MTP May'18, March'20, March'21, Nov'22)

During 20X4-X5, Cheery Limited discovered that some products that had been sold during 20X3-X4 were incorrectly included in inventory at 31st March, 20X4 at ₹ 6,500.

Cheery Limited's accounting records for 20X4-X5 show sales of ₹ 104,000, cost of goods sold of ₹ 86,500 (including ₹ 6,500 for the error in opening inventory), and income taxes of ₹ 5,250.

In 20X3-X4, Cheery Limited reported:

	₹
Sales	73,500
Cost of goods sold	(53,500)
Profit before income taxes	20,000
Income taxes	(6,000)
Profit	14,000
Basic and diluted EPS	2.8

The 20X3-X4 opening retained earnings was ₹ 20,000 and closing retained earnings was ₹ 34,000. Cheery Limited's income tax rate was 30% for 20X4-X5 and 20X3-X4. It had no other income or expenses.

Cheery Limited had ₹ 50,000 (5,000 shares of ₹ 10 each) of share capital throughout, and no other components of equity except for retained earnings.

State how the above will be treated /accounted in Cheery Limited's Statement of profit and loss, statement of changes in equity and in notes wherever required for current period and earlier period(s) as per relevant Ind AS.

(8 to 12 Marks)

SOLUTION

Cheery Limited
Extract from the Statement of profit and loss

	20X4-X5 ₹	(Restated) 20X3-X4 ₹
Sales	1,04,000	73,500
Cost of goods sold	(80,000)	(60,000)
Profit before income taxes	24,000	13,500
Income taxes	(7,200)	(4,050)
Profit	16,800	9,450
Basic and diluted EPS	3.36	1.89

Cheery Limited
Statement of Changes in Equity

	Share capital	Retained earnings	Total
Balance at 31st March, 20X3	50,000	20,000	70,000
Profit for the year ended 31st March, 20X4 as restated		9,450	9,450
Balance at 31st March, 20X4	50,000	29,450	79,450
Profit for the year ended 31st March, 20X5		16,800	16,800
Balance at 31st March, 20X5	50,000	46,250	96,250

Extract from the Notes

Some products that had been sold in 20X3-X4 were incorrectly included in inventory at 31st March, 20X4 at ₹ 6,500. The financial statements of 20X3-X4 have been restated to correct this error. The effect of the restatement on those financial statements is summarized below:

	Effect on 20X3-X4
(Increase) in cost of goods sold	(6,500)
Decrease in income tax expenses	1,950
(Decrease) in profit	(4,550)
(Decrease) in basic and diluted EPS	(0.91)
(Decrease) in inventory	(6,500)
Decrease in income tax payable	1,950
(Decrease) in equity	(4,550)

There is no effect on the balance sheet at the beginning of the preceding period i.e. 1st April, 20X3.

Illustration 19 - (RTP May'21, May'23)

In 20X3-20X4, after the entity's 31 March 20X3 annual financial statements were approved for issue, a latent defect in the composition of a new product manufactured by the entity was discovered (that is, a defect that could not be discovered by reasonable or customary inspection). As a result of the latent defect the entity incurred ₹100,000 in unanticipated costs for fulfilling its warranty obligation in respect of sales made before 31 March 20X3. An additional ₹20,000 was incurred to rectify the latent defect in products sold during 20X3-20X4 before the defect was detected and the production process rectified, ₹5,000 of which relates to items of inventory at 31 March 20X3. The defective inventory was reported at cost ₹ 15,000 in the 20X2-20X3 financial statements when its selling price less costs to complete and sell was estimated at ₹18,000. The accounting estimates made in preparing the 31 March 20X3 financial statements were appropriately made using all reliable information that the entity could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. Analyse the above situation in accordance with relevant Ind AS.

Solution:

Ind AS 8 is applied in selecting and applying accounting policies, and accounting for changes in accounting

policies, changes in accounting estimates and corrections of prior period errors.

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. This change in accounting estimate is an outcome of 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.

Further, the effect of change in an accounting estimate, 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.

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.

On the basis of above provisions, the given situation would be dealt as follows:

The defect was neither known nor reasonably possible to detect at 31 March 20X3 or before the financial statements were approved for issue, so understatement of the warranty provision ₹ 1,00,000 and overstatement of inventory ₹ 2,000 (refer working note) in the 31 March 20X3 financial statements are not a prior period errors.

The effects of the latent defect that relate to the entity's financial position at 31 March 20X3 are changes in accounting estimates.

In preparing its financial statements for 31 March 20X3, the entity made the warranty provision and inventory valuation appropriately using all reliable information that the entity could reasonably be expected to have obtained and had taken into account the same in the preparation and presentation of those financial statements.

Consequently, the additional costs are expensed in calculating profit or loss for 20X3-20X4.

Working Note:

Inventory is measured at the lower of cost (ie ₹ 15,000) and net realisable value (ie ₹ 18,000 originally estimated minus ₹ 5,000 costs to rectify latent defect = ₹ 13,000). Therefore, defective inventory was overstated by ₹ 2,000 (₹ 15,000 – ₹ 13,000) in the year 20X2-20X3.

REVISION TEST PAPER / IAS / EXAM

Question 1 - (MTP May'20)

During the year ended 31st March, 20X2, Blue Ocean group changed its accounting policy for depreciating property, plant and equipment, so as to apply components approach fully, whilst at the same time adopting the revaluation model.

In years before 20X1-20X2, Blue Ocean group's asset records were not sufficiently detailed to apply a components approach fully. At the end of 31st March, 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 20X1-20X2.

The results are shown as under:

Property, plant and equipment at the end of 31st March, 20X1

	Rs.
Cost	25,000
Depreciation	(14,000)
Net book value	11,000
Depreciation expense for 20X1-20X2 (on old basis)	1,500
Some results of the engineering survey:	
Valuation	17,000
Estimated residual value	3,000
Average remaining asset life (years)	7

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.

The board of directors 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 20X1-20X2.

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 Blue Ocean group's new policy prospectively from the start of 20X1-20X2.

Blue Ocean group's tax rate is 30 per cent.

Compute the impact of change in accounting policy related to change in carrying amount of Property, Plant & Equipment under revaluation method and impact on taxes based on the basis of information provided. Show the impact of each item affected on financial statements by the analysis of stated issue. **(6 Marks)**

Solution:

As per Ind AS 8 'Accounting Policies, Accounting Estimates and Errors, prospective application of a change in accounting policy has to be done since retrospective application is not practicable.

Property, plant and equipment at the end of 31st March, 20X2:

As per the engineering survey:

Valuation of PPE 17,000

Estimated residual value 3,000

Average remaining asset life (years) 7

Depreciation expense on existing property, plant and equipment

for 20X1-20X2 (new basis) $(17,000 - 3,000)/7$ 2,000

From the start of 20X1-20X2, Blue Ocean group changed its accounting policy for depreciating property, plant and equipment, so as to apply 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 the year 20X1-20X2 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 impact on the financial statements for 20X1-20X2 would be as under:

Particulars	Rs.
Increase the carrying amount of property, plant and equipment at the start of the year (17,000-11,000)	6,000
Increase the opening deferred tax provision (6,000 x 30%)	1,800
Create a revaluation surplus at the start of the year (6,000 – 1,800)	4,200
Increase depreciation expense by (Rs.2,000 – Rs.1,500)	500
Reduce tax expense on depreciation (30%)	150

Question 2 - (MTP Nov'21)

Given the decreased revenue in financial year 20X1-20X2, management of PQR Ltd is keen to identify ways to reduce the overall impact on profit and loss. A consultant has suggested that they could explore changing the basis of depreciation from SLM to hours-in-use but not entirely sure if this is permitted. Annual depreciation charge for financial year 20X1-20X2 would be ₹ 25 lacs using SLM and ₹ 7 lacs using new method. This difference is significant for PQR Ltd.'s financial statements.

What are the considerations in determining whether a change in depreciation methodology is appropriate, and how should this change be accounted for? Given the risk of charging lower depreciation per annum and the possibility that the asset will be depreciated over a period longer than it would otherwise be (under SLM basis), what other safeguards do you suggest, in order to ensure compliance with relevant standards in Ind AS and its framework? (6 Marks)

Solution:

As illustrated in per para 32 of Ind AS 8, Change in method of depreciation is a change in accounting estimates.

Considerations in determining whether the change in depreciation methodology is appropriate:

Paragraphs 60 and 61 of Ind AS 16, Property, Plant and Equipment, state that 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 shall be 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 shall be changed to reflect the changed pattern.

Accounting procedure:

Such a change is accounted for as a change in an accounting estimate in accordance with Ind AS 8.

Depreciation is a function of several factors, with extent of usage and efflux of time being its primary determinants. The hours-in-use method relates the amount of periodic depreciation charge only to one of the above two factors, namely, the extent of usage as reflected by the number of hours. This method may therefore be said to be appropriate as per para 62 of Ind AS 16.

Determination of depreciation method involves an accounting estimate; depreciation method is not a matter of an accounting policy. Accordingly, as per Ind AS 8 and Ind AS 16, a change in depreciation method shall be accounted for as a change in accounting estimate, i.e; prospectively.

However, given the possibility that the asset will be depreciated over a period longer than it would be under SLM basis, the company will need to assess if there are any impairment triggers and carry out impairment testing as required under Ind AS 36.

Question 3 (RTP Nov'23)

In its financial statements for the year ended 31st March, 20X2, Y Ltd. reported ₹ 73,500 revenue (sales), ₹ 53,500 cost of sales, ₹ 6,000 income tax expense, ₹ 20,000 retained earnings at 1st April, 20X1 and ₹ 34,000 retained earnings at 31st March, 20X2.

In 20X2-20X3, after the 20X1-20X2 financial statements were approved for issue, Y Ltd. discovered that some products sold in 20X1-20X2 were incorrectly included in inventories at 31st March, 20X2 at their cost of ₹ 6,500.

In 20X2-20X3, Y Ltd. changed its accounting policy for the measurement of investments in associates after initial recognition from cost model to the fair value model as per Ind AS 109. It acquired its only investment in an associate for ₹ 3,000 many years ago. The associate's equity is not traded on a securities exchange (that is, a published price quotation is not available). The fair value of the investment was determined reliably using an appropriate equity valuation model on 31st March, 20X3 at ₹ 25,000 (20X1-20X2: ₹ 20,000 and 20X0-20X1: ₹ 18,000).

At 31st March, 20X3, as a result of usage of improved lubricants, Y Ltd. reassessed the useful life of Machine A from four years to seven years. Machine A is depreciated on the straight-line method to a Nil residual value. It was acquired for ₹ 6,000 on 1st April, 20X0.

Inventories of the type manufactured by Machine A were immaterial at the end of each reporting period.

Y Ltd.'s accounting records for the year ended 31st March, 20X3, before accounting for change in accounting policy and change in accounting estimate, record ₹ 1,04,000 revenue (sales), ₹ 86,500 cost of sales (including ₹ 6,500 for the error in opening inventory and ₹ 1,500 depreciation for Machine A) and ₹ 5,250 income tax expense.

Y Ltd. presents financial statements with one year of comparative information.

For simplicity, the tax effect of all items of income and expenses should be assumed to be 30% of the gross amount.

Draft an extract showing how the correction of the prior period error, change in accounting policy and change in accounting estimate could be presented in the Statement of Profit and Loss and Statement of Changes in Equity (Retained Earnings) and disclosed in the Notes of Y Ltd. for the year ended 31st March, 20X3.

Solution:

Extract of Y Ltd.'s Statement of Profit and Loss for the year ended 31st March, 20X3

	20X2-20X3	Reference to W.N.	20X1- 20X2 Restated	Reference to W.N.
	₹		₹	
Revenue	<u>1,04,000</u>		<u>73,500</u>	

Cost of sales (20X1-20X2 previously ₹ 53,500)	(79,100)	1	(60,000)	4
Gross profit	24,900		13,500	
Other income — change in the measurement policy i.e. the value of investment in associate at FVTPL	5,000	2	2,000	5
Profit before tax	<u>29,900</u>		<u>15,500</u>	
Income tax expense	<u>(8,970)</u>	3	<u>(4,650)</u>	6
Profit for the year	<u>20,930</u>		<u>10,850</u>	

Extract of Y Ltd.'s Statement of Changes in Equity (Retained Earnings)
for the year ended 31st March, 20X3

	20X2-20X3	Reference to W.N.	20X1-20X2 Restated	Reference to W.N.
	₹		₹	
Retained earnings, as restated, at the beginning of the year				
- as previously stated	34,000		20,000	
- effect of the correction of a prior period error	(4,550)	7	-	
- effect of a change in accounting policy	<u>11,900</u>	13	<u>10,500</u>	12
	41,350		30,500	
Profit for the year	<u>20,930</u>		<u>10,850</u>	
Retained earnings at the end of the year	<u>62,280</u>		<u>41,350</u>	

Y Ltd.

Extract of Notes to the Financial Statements for the year ended 31st March, 20X3

Note X : Change in Accounting Estimates

Due to usage of improved lubricants the estimated useful life of the machine used for production was increased from four years to seven years. The effect of the change in the useful life of the machine is to reduce the depreciation allocation by ₹ 900 in 20X2-20X3 and 20X3-20X4. The after-tax effect is an increase in profit for the year of ₹ 630 for each of the two years.

Depreciation expense in 20X4-20X5 to 20X6-20X7 is increased by ₹ 600 because of revision in the useful life of machinery, as under the initial estimate, the asset would have been fully depreciated at the end of 20X3-20X4. The after-tax effect for these three years is a decrease in profit for the year by ₹ 420 per year.

Note Y : Correction of Prior Period Error

In 20X2-20X3 the entity identified that ₹ 6,500 products that had been sold in 20X1-20X2 were included erroneously in inventory at 31st March, 20X2. The financial statements of 20X1-20X2 have been restated to correct this error. The effect of the restatement is ₹ 6,500 increase in the cost of sales and ₹ 4,550 decrease in profit for the year ended 31st March, 20X2 after decreasing income tax expense by ₹ 1,950.

This resulted in ₹ 4,550 (decrease) restatement of retained earnings at 31st March, 20X2.

Note Z : Change In Accounting Policy

In 20X2-20X3 the entity changed its accounting policy for the measurement of investments in associates from cost model to fair value model as per Ind AS 109. Management judged that this policy provides reliable and more relevant information because dividend income and changes in fair value are inextricably linked as integral components of the financial performance of an investment in an associate and

measurement at fair value is necessary if that financial performance is to be reported in a more meaningful way. This change in accounting policy has been accounted for retrospectively. The comparative information has been restated. A new line item, 'Other income — change in the fair value of investment in associate', has been added in the Statement of Profit and Loss and Retained Earnings. The effect of the restatement has been to add income of ₹ 2,000 as a result of the increase in value of the associate during the year ended 31st March, 20X2 which resulted in ₹ 1,400 increase in profit for the year (after including a resulting increase in income tax expense of ₹ 600). This, together with ₹ 10,500 (increase) restatement of retained earnings at 31st March, 20X1, resulted in a ₹ 11,900 increase in retained earnings at 31st March, 20X2. Furthermore, profit for the year ended 31st March, 20X3 was ₹ 3,500 higher (after deducting ₹ 1,500 tax effect) as a result of recording a further ₹ 5,000 (W.N.2) increase in the fair value of the investment in an associate.

Working Notes:

1. ₹ 86,500 (given) minus ₹ 6,500 correction of error (now recognised as an expense in 20X1-20X2) minus ₹ 900 (W.N.9) effect of the change in accounting estimate.
2. ₹ 25,000 fair value (20X2-20X3) minus ₹ 20,000 fair value (20X1-20X2) = ₹ 5,000 (the effect of applying the new accounting policy (fair value model) in 20X2-20X3).
3. ₹ 5,250 + ₹ 1,950 (W.N.8) + 30% (₹ 900 (W.N.9) reduction in depreciation resulting from the change in accounting estimate) + 30% (₹ 5,000 increase in the fair value of investment property — change in accounting policy) = ₹ 8,970.
4. ₹ 53,500 as previously stated + ₹ 6,500 (products sold and incorrectly included in closing inventory in 20X1-20X2) = ₹ 60,000 (that is, the prior period error is corrected retrospectively by restating the comparative amounts).
5. ₹ 20,000 fair value (20X1-20X2) minus ₹ 18,000 fair value (20X0-20X1) = ₹ 2,000 (the effect in 20X1-20X2 of the change in accounting policy for investments in associates from the cost model to the fair value model).
6. ₹ 6,000 as previously stated minus ₹ 1,950 (W.N.8) correction of prior period error + 30% (₹ 2,000 change in accounting policy) = ₹ 4,650.
7. ₹ 6,500 (products sold and incorrectly included in inventory in 20X1-20X2) — ₹ 1,950 (W.N.8) (tax overstated in 20X1-20X2) = ₹ 4,550.
8. ₹ 6,500 (products sold and incorrectly included in inventory in 20X1-20X2) x 30% (income tax rate) = ₹ 1,950.
9. ₹ 1,500 depreciation (using old estimate, that is, ₹ 6,000 cost ÷ 4 years) minus ₹ 600 (W.N.10) (using new estimate of useful life) = ₹ 900.
10. ₹ 3,000 (W.N.11) carrying amount ÷ 5 years remaining useful life = ₹ 600 depreciation per year.
11. [₹ 6,000 cost minus (₹ 1,500 depreciation x 2 years)] = ₹ 3,000 carrying amount at 31st March, 20X2.
12. (₹ 18,000 fair value of investment in associates at 31st March, 20X1 minus ₹ 3,000 carrying amount based on the cost model at the same date) x 0.7 (to reflect 30% income tax rate) = ₹ 10,500 (effect of a change in accounting policy (from cost model to fair value model)).
13. ₹ 10,500 (W.N.12) + [₹ 2,000 (W.N.5) x 0.7 (to reflect 30% income tax rate)] = ₹ 11,900.

Question 4 (Past Exam Nov'23)

HG Incredibles Limited had in the recent past made a right issue. In its offer document to its members, it had projected a surplus of ₹ 50 crores during the year ending 31.03.2023. The draft result for the year ended 31.03.2023, prepared on the hitherto followed accounting policies and presented for perusal of the Board of Directors showed a surplus of ₹ 5 Crores. The Board in consultation with the Managing Director, decided on the following:

- (i) Value year-end Inventory at Works Cost (₹ 40 Crores) instead of hitherto method of valuation of inventory at Prime Cost (₹ 20 Crores);

- (ii) Not to provide for "After Sales Expenses" during the warranty period. Till the last year, provision for 1% of Sales used to be made under the concept of "matching of costs against revenue" and actual expenses used to be charged against provision. The Board now decided to account for expenses as and when actually they are incurred. Sales during the year was ₹ 800 Crores;
- (iii) Provide depreciation for the year on Straight Line Method on account of substantial additions in Gross Block during the year, instead of on Reducing Balance Method, which was hitherto adopted. As a consequence, ₹ 21 Crores depreciation is now less charged than it would have been provided under the old method. (₹ 67 Crores on Reducing Balance method and ₹ 46 Crores in Straight Line Method).
- (iv) Provide for other than temporary fall in the value of investments, which fall took place in last 6 years, amounting to ₹ 12 Crores. Discuss the above situations as per applicable Ind AS, particularly Ind AS 8. Whether the above are changes in accounting policies or changes in estimates? **(5 Marks)**

Solution:

- (i) 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. The entity should apply the change in the accounting policy retrospectively. For retrospective application of a change in accounting policy, adjust the opening balance of each affected component 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. Usually, the adjustment is made to retained earnings.

Income tax effect due to change in accounting policy will be accounted for in accordance with Ind AS 12.

- (ii) Here, since the question talks about making of provision, it is assumed that assurance warranty has been provided by the entity. Further, providing for 1% against after sales expenses is an accounting policy decision. Now since, the company has decided not to make provision for such expenses but to account for the same as and when expenses are incurred, there is a change in accounting policy decision.

The change in accounting policy is accounted for retrospectively. For retrospective application of a change in accounting policy, adjust the opening balance of each affected component 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. Usually, the adjustment is made to retained earnings.

Income tax effect due to change in accounting policy will be accounted for in accordance with Ind AS 12.

- (iii) Determination of depreciation method involves an accounting estimate and thus depreciation method is not a matter of an accounting policy. Accordingly, 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. Change in accounting estimate is accounted for prospectively. However, the effect of the change is recognised as income or expense of the year in which the change is made. The effect, if any, on future periods is recognised as income or expense in those future periods.

- (iv) Accounting for investment made by the entity falls under the purview of Ind AS 109 'Financial Instruments'. As per Ind AS 109, subsequent measurement of financial instruments is done on following basis:

- Measured at Amortised cost
- Measured at Fair value through Other Comprehensive Income (FVTOCI)
- Measured at Fair value through Profit or Loss (FVTPL)

In case the entity has subsequently measured its financial asset i.e. investment on the basis of FVTOCI or FVTPL, then change in fair value would have been recorded earlier in previous reporting period too. In such a case, there is no change in accounting policy or accounting estimate. However, if the entity

had not accounted for previous changes in its books, then it is an error. 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. Further, fair value change is to be accounted for at every reporting date. Hence, restatement of the comparative amounts for the prior period(s) presented in which the error occurred is also required to be done.

Further, 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. Reclassification of financial asset will be accounted for in accordance with the guidance given in

Ind AS 109.

IND AS 10 – EVENTS AFTER THE REPORTING DATE

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 i.e. the date when the partner(s) of the firm approve(s) the financial statements.

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.

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

As per paragraph 3 of Ind AS 10, the 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. Therefore, in the given case, the date of approval for issue as per Ind AS 10 should be considered as June 30, 20X2.

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 but before the financial statements are approved 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.

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.

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.

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.

Illustration 8 – (RTP May'19)

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 by 31st December 20X5. 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 - (RTP Nov'20) (MTP March'22)

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 ₹ 40,00,000 is estimated. The claim with the insurance company has been filed and a recovery of ₹ 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? **(4 Marks)**

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 material 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.

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 was 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.

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 recognized 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 is not relevant for its recognition.

Illustration 12 (MTP May'24)

The AGM of ABC Ltd for the year ended 31st March, 20X2 was held on 10th July, 20X2 and Board Meeting has been conducted on 15th May, 20X2. Meanwhile, the company had to disclose certain financial information pertaining to the year ended 31st March, 20X2 to SEBI as per SEBI regulations on 20th April, 20X2. Since, certain financial information pertaining to the year ended 31st March, 20X2 is submitted to SEBI before approval of financial statements by the Board, the management is suggesting that 20th April 20X2 shall be considered as 'after the reporting period'. Whether the management view is correct in accordance with the guidance given in Ind AS 10? (4 Marks)

Solution:

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 the reporting period and the date of approval of financial statements. In the above case, the financial statements for the year 20X1-20X2 were approved on 15th May, 20X2. Therefore, for the purposes of Ind AS 10, 'after the reporting period' would be the period between 31st March, 20X2 and 15th May, 20X2.

Illustration 13

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.

Solution:

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.

Illustration 14

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 laptop's 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.

Solution:

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.

Illustration 15

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?

Solution:

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.

Illustration 16

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?

Solution:

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.

Illustration 17

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?

Solution:

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.

Illustration 18 (RTP – May'22)

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.

Solution:

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.

Illustration 19

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?

Solution:

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.

Illustration 20

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?

Solution:

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.

Illustration 21 – (RTP – Nov 2019)

ABC Ltd. received a demand notice on 15th June, 20X2 for an additional amount of ₹ 28,00,000 from the Excise Department on account of higher excise duty levied by the Excise Department compared to the rate at which the company was creating provision and depositing the same in respect of transactions related to financial year 20X1-20X2. The financial statements for the year 20X1-20X2 are approved on 10th August, 20X2. In July, 20X2, the company has appealed against the demand of ₹ 28,00,000 and the company has expected that the demand would be settled at ₹ 15,00,000 only. Show how the above event will have a bearing on the financial statements for the year 20X1-20X2. Whether these events are adjusting or non-adjusting events and explain the treatment accordingly.

Solution:

Ind AS 10 defines „Events after the Reporting Period“ as follows:

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:

- those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period); and
- those that are indicative of conditions that arose after the reporting period (non-adjusting events after the reporting period)

In the instant case, the demand notice has been received on 15th June, 20X2, which is between the end of the reporting period and the date of approval of financial statements. Therefore, it is an event after the reporting period. This demand for additional amount has been raised because of higher rate of excise duty levied by the Excise Department in respect of goods already manufactured during the reporting period. Accordingly, condition exists on 31st March, 20X2, as the goods have been manufactured during the

reporting period on which additional excise duty has been levied and this event has been confirmed by the receipt of demand notice. Therefore, it is an adjusting event.

In accordance with the principles of Ind AS 37, the company should make a provision in the financial statements for the year 20X1-20X2, at best estimate of the expenditure to be incurred, i.e., ₹ 15,00,000.

Question 1 (RTP - MAY 2018)

Mac Ltd. purchased goods on credit from Toy Ltd. for ₹580 lakhs for export. The export order was cancelled. Mac Ltd. decided to sell the same goods in the local market with a price discount. Toy Ltd. was requested to offer a price discount of ₹10%. Toy Ltd. wants to adjust the sales figure to the extent of the discount requested by Mac Ltd. Discuss whether such a treatment in the books of Toy Ltd. is justified as per the provisions of the relevant Ind AS. Also, Toy Ltd. entered into a sale deed for its Land on 15th March, 20X1. But registration was done with the registrar on 20th April, 20X1. But before registration, is it possible to recognize the sale and the gain at the balance sheet date? Give reasons in support of your answer.

Solution

Toy Ltd. had sold goods to Mac Ltd on credit worth for ₹580 lakhs and the sale was completed in all respects. Mac Ltd.'s decision to sell the same in the domestic market at a discount does not affect the amount recorded as sales by Toy Ltd.

The price discount of 10% offered by Toy Ltd. after request of Mac Ltd. was not in the nature of a discount given during the ordinary course of trade because otherwise the same would have been given at the time of sale itself. However, there appears to be an uncertainty relating to the collectability of the debt, which has arisen subsequent to sale. Therefore, it would be appropriate to make a separate provision to reflect the uncertainty relating to collectability rather than to adjust the amount of revenue originally recorded. Hence such discount should be charged to the Statement of Profit and Loss and not shown as deduction from the sales figure.

With respect to sale of land, both sale and gain on sale of land earned by Toy Ltd. shall be recognized in the books at the balance sheet date. In substance, the land was transferred with significant risk & rewards of ownership to the buyer before the balance sheet date and what was pending was merely a formality to register the deed. The registration post the balance sheet date only confirms the condition of sale at the balance sheet date as per Ind AS 10 "Events after the Reporting Period."

Question 2 (RTP MAY'18, MTP Nov'23)

On 31 March 20X1, the inventory of ABC includes spare parts which it had been supplying to a number of different customers for some years. The cost of the spare parts was ₹ 10 million and based on retail prices at 31 March 20X1, the expected selling price of the spare parts is ₹ 12 million. On 15 April 20X1, due to market fluctuations, expected selling price of the spare parts in stock reduced to ₹ 8 million. The estimated selling expense required to make the sales would ₹ 0.5 million. Financial statements were authorised by Board of Directors on 20th April 20X1.

As at 31st March 20X2, Directors noted that such inventory is still unsold and lying in the warehouse of the company. Directors believe that inventory is in a saleable condition and active marketing would result in an immediate sale. Since the market conditions have improved, estimated selling price of inventory is ₹ 11 million and estimated selling expenses are same ₹ 0.5 million.

What will be the value inventory at the following dates:

(a) 31st March 20X1

(b) 31st March 20X2

(4 Marks)

Solution

As per Ind AS 2 'Inventories', inventory is measured at lower of 'cost' or 'net realisable value'. Further, as per Ind AS 10: 'Events after Balance Sheet Date', decline in net realisable value below cost provides additional evidence of events occurring at the balance sheet date and hence shall be considered as 'adjusting events'.

(a) In the given case, for valuation of inventory as on 31 March 20X1, cost of inventory would be ₹ 10 million and net realisable value would be ₹ 7.5 million (i.e. Expected selling price ₹ 8 million- estimated selling expenses ₹ 0.5 million). Accordingly, inventory shall be measured at ₹ 7.5 million i.e. lower of cost and net realisable value. Therefore, inventory write down of ₹ 2.5 million would be recorded in income statement of that year.

(b) As per para 33 of Ind AS 2, a new assessment is made of net realizable value in each subsequent period. It Inter alia states that if there is increase in net realizable value because of changed economic circumstances, the amount of write down is reversed so that new carrying amount is the lower of the cost and the revised net realizable value. Accordingly, as at 31 March 20X2, again inventory would be valued at cost or net realisable value whichever is lower. In the present case, cost is ₹ 1 million and net realisable value would be ₹ 10.5 million (i.e. expected selling price ₹ 11 million – estimated selling expense ₹ 0.5 million). Accordingly, inventory would be recorded at ₹ 10 million and inventory write down carried out in previous year for ₹ 2.5 million shall be reversed.

Question 3 (PAST EXAM Nov'19) (MTP Mar'21 Nov'21)

Discuss with reasons whether these events are in nature of adjusting or non-adjusting and the treatment needed in light of accounting standard Ind AS 10.

- i) Moon Ltd. won an arbitration award on 25th April, 2019 for ₹ 1 crore. From the arbitration proceeding, it was evident that the Company is most likely to win the arbitration award. The directors approved the financial statements for the year ending 31.03.2019 on 1st May, 2019. The management did not consider the effect of the above transaction in Financial Year 2018-2019, as it was favourable to the Company and the award came after the end of the financial year.
- ii) Zoom Ltd. has a trading business of Mobile telephones. The Company has purchased 1000 mobiles phones at ₹ 5,000 each on 15th March, 2019. The manufacturers of phone had announced the release of the new version on 1st March, 2019 but had not announced the price. Zoom Ltd. has valued inventory at cost of ₹ 5,000 each at the year ending 31st March, 2019. Due to arrival of new advance version of Mobile Phone on 8th April, 2019, the selling prices of the mobile stocks remaining with Company was dropped at ₹ 4,000 each. The financial statements of the company valued mobile phones @ ₹ 5,000 each and not at the value @ ₹ 4,000 less expenses on sales, as the price reduction in selling price was effected after 31.03.2019.
- iii) There as an old due from a debtor amounting to ₹ 15 lakh against whom insolvency proceedings was instituted prior to the financial year ending 31 st March, 2019. The debtor was declared insolvent on 15th April, 2019.
- iv) Assume that subsequent to the year end and before the financial statements are approved, Company's management announces that it will restructure the operation of the company. Management plans to make significant redundancies and to close a few divisions of company's business; however, there is no formal plan yet. Should management recognise a provision in the books, if the company decides subsequent to end of the accounting year to restructure its operations?

(8 Marks)

Solution:

As per Ind AS 10, the treatment of stated issues would be as under:

- i) **Adjusting event:** It is an adjusting event as it is 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. Even though winning of award is favorable to the company, it should be accounted in its books as receivable since it is an adjusting event.
- ii) **Adjusting event:** The sale of inventories after the reporting period may give evidence about their net realizable value at the end of the reporting period, hence it is an adjusting event as per Ind AS 10. Zoom Limited should value its inventory at ₹ 40,00,000. Hence, appropriate provision must be made for ₹ 15 lakh.
- iii) **Adjusting event:** As per Ind AS 10, 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.
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.
- iv) **Non – adjusting event:** Announcing or commencing the implementation of a major restructuring after reporting period is a non-adjusting event as per Ind AS 10. Though this is a non-adjusting event occurred after the reporting period, yet it would result in disclosure of the event in the financial statements, if restructuring is material.

This would not require provision since as per Ind AS 37, decision to restructure was not taken before or on the reporting date. Hence, it does not give rise to a constructive obligation at the end of the reporting period to create a provision.

Question 4 (Past Exam Jan'21)

H Ltd. constructed a warehouse at a cost of ₹ 10 lakhs in 2015. It first became available for use by H Ltd. on 1st January 2016. On 29th January 2020, H Ltd. discovered that its warehouse was damaged. During early February 2020, an investigation revealed that the damage was due to a structural fault in the construction of the warehouse. The fault became apparent when the warehouse building leaked severely after heavy rainfall in the week ended 27th January 2020. The discovery of the fault is an indication of impairment. So, H Ltd. was required to estimate the recoverable amount of its warehouse at 31st December 2019. This estimate was ₹ 6,00,000. Furthermore, H Ltd. reassessed the useful life of its warehouse at 20 years from the date that it was ready for use. Before discovering the fault, H Ltd. had depreciated the warehouse on the straight-line method to a nil residual value over its estimated 30-year useful life.

Seepage of rain water through the crack in the warehouse caused damage to inventory worth about ₹ 1,00,000 (cost price) and became un-saleable. The entire damaged inventory was on hand as at 31st December, 2019. H Ltd. has not insured against any of the losses.

It accounts for all its property, plant and equipment under the cost model. H Ltd.'s annual financial statements for the year ended 31st December, 2019 were approved for issue by the Board of Directors on 28th February, 2020.

You are required to :

- Prepare accounting entries to record the effects of the events after the end of the reporting period in the accounting records of H Ltd. for the year ended 31st December, 2019. Kindly ignore tax impact;
- Discuss disclosure requirement in above case as per relevant Ind AS; and
- Will your answer be different if there was no structural fault and damage to the warehouse had been caused by an event that occurred after 31 st December, 2019? **(8 Marks)**

Solution:

(i) Journal Entries on 31st December 2019

	₹	₹
Depreciation expense A/c (W.N.1) Dr. To Warehouse or Accumulated depreciation A/c (Being additional depreciation expense recognised for the year ended 31st December 2019 arising from the reassessment of the useful life of the warehouse)	19,608	19,608
Impairment loss A/c (W.N.2) Dr. To Warehouse or Accumulated depreciation A/c (Being impairment loss recognised due to discovery of structural fault in the construction of warehouse at 31st December 2019)	2,47,059	2,47,059

- (ii)(a) The damage to warehouse is an adjusting event (occurred after the end of the year 2019) for the reporting period 2019, since it provides evidence that the structural fault existed at the end of the reporting period. It is an adjusting event, in spite of the fact that fault has been discovered after the reporting date.

The effects of the damage to the warehouse are recognised in the year 2019 reporting period. Prior periods will not be adjusted because those financial statements were prepared in good faith (eg regarding estimate of useful life, assessment of impairment indicators etc) and had not affected the financials of prior years.

(b) Damage of inventory due to seepage of rainwater ₹ 1,00,000 occurred during the year 2020. It is a non-adjusting event after the end of the 2019 reporting period since the inventory was in good condition at 31st December 2019. Hence, no accounting has been done for it in the year 2019.

H Ltd. must disclose the nature of the event (i.e. rain-damage to inventories) and an estimate of the financial effect (i.e. ₹ 1,00,000 loss) in the notes to its 31st December 2019 annual financial statements.

- (iii) If the damage to the warehouse had been caused by an event that occurred after 31st December 2019 and was not due to structural fault, then it would be considered as a non-adjusting event after the end of the reporting period 2019 as the warehouse would have been in a good condition at 31st December 2019.

Working Notes:

1. Calculation of additional depreciation to be charged in the year 2019

Original depreciation as per SLM already charged during the year 2019

$$= ₹ 10,00,000 / 30 \text{ years} = ₹ 33,333.$$

Carrying value at the end of 2018

$$= 10,00,000 - (₹ 33,333 \times 3 \text{ years}) = ₹ 9,00,000$$

Revised depreciation

$$= 9,00,000 / 17 \text{ years} = ₹ 52,941$$

Additional depreciation to be recognised in the books in the year 2019

$$= ₹ 52,941 - ₹ 33,333 = ₹ 19,608$$

2. Calculation of impairment loss in the year 2019

Carrying value after charging depreciation for the year 2019

$$= ₹ 9,00,000 - ₹ 52,941 = ₹ 8,47,059$$

Recoverable value of the warehouse

$$= ₹ 6,00,000$$

Impairment loss

$$= \text{Carrying value} - \text{Recoverable value}$$

$$= ₹ 8,47,059 - ₹ 6,00,000 = ₹ 2,47,059$$

Question 5 (MTP April'19)

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 Rs. 8 lakhs. The net realisable value of the inventory prior to the damage was estimated at Rs. 9.60 lakhs. Because of the damage caused to the consignment of inventory, the company was required to spend an additional amount of Rs. 2 lakhs on repairing and re-packaging of the inventory. The inventory was sold on 15th May, 20X2 for proceeds of Rs. 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:

	Rs. 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 31.03.20X2 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 approving⁶ 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 Rs. 8 lakhs calculated below:

Rs. lakhs

Cost	8.00
Net realisable value	9.60
Inventories (lower of cost and net realisable value)	8.00

Question 6 (Past Exam May'23)

Discuss the following situations as per Ind AS 10:

- i. The financial statements of a Company for the year 2021-2022 are approved by the management and were sent on 5th June, 2022 for review and approval to its supervisory board i.e., Board of Directors. The supervisory board approves the financial statements on 26th June, 2022. The financial statements are then made available to shareholders on 4th July, 2022. The financial statements are approved by shareholders in their annual general meeting on 18th August, 2022 and then filed with Ministry of Corporate Affairs (MCA) on 19th August, 2022. Determine & discuss the date on which financial statements were approved.
- ii. A Company is in litigation with Income Tax Department with respect to allowability of certain exemptions for financial year 2018-2019. No provision for tax has been made for disallowances of exemptions as the Company was under bonafide belief based on a legal opinion that it will succeed in litigation. On 21st April, 2023, the Hon'ble Supreme Court rejected the Company's claim. The Order is received on 30th April, 2023. The financial statements for the financial year 2022-2023 of the Company are yet to be approved. The earlier year's financial statements stands approved. Advise in financial statements of which financial year the impact of the Order of the Hon'ble Supreme Court should be recognized.
- iii. Z Limited while preparing its financial statements on 31st March, 2023 made a provision for doubtful debts @ 6% on accounts receivables. In the last week of January, 2023, a debtor for ₹ 3 lakhs had suffered heavy loss due to fire; the loss was not covered by any insurance policy. Z Limited, considering the event of fire made a provision @ 60% of the amount receivables from that debtor apart from the general provision @ 6% on remaining debtors. The same debtor was declared insolvent on 10th April, 2023. The financial statements have not yet been approved. You are required to suggest whether the

company should provide for the full loss arising out of insolvency of the debtor in the financial statements for the year ended 31st March, 2023.

- iv. D Limited acquired equity shares of another company on 1st March, 2023 at a cost of ₹ 28 lakhs. The fair market value of these shares on 31st March, 2023 was ₹ 35 lakhs and the company measured it at ₹ 35 lakhs (assume that it is classified as FVTOCI as per Ind AS 109 and change in fair value is transferred to 'fair value fluctuation reserve'). Due to market conditions subsequent to the reporting date, the value of investments drastically came down to ₹ 20 lakhs. The financial statements have not yet been approved. You are required to suggest whether D Limited should value the investments at ₹ 35 lakhs or ₹ 20 lakhs as on 31st March, 2023.
- v. Tanmay Limited was in negotiation with Varun Limited from 1st December, 2022 to acquire land for ₹ 5.00 crores. The negotiations were concluded in the first week of April 2023. The transaction was completed by last week of April, 2023. In which financial year, the purchase of land should be recognized? (5 Marks)

Solution:

- i. As per Ind AS 10, in the case of a company, the financial statements will be treated as approved when board of directors approves the same. Hence in the given case, the financial statements are approved for issue on 26th June, 2022 (date of approval by the Board of Directors for issue of financial statements to the shareholders).
- ii. 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. Court order received after the reporting period (but before the financial statements are approved) provides 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 amount will be adjusted in financial statements for the financial year 2022-2023.
- iii. In the instant case, the fire took place in January, 2023 (i.e. before the end of the reporting period). Therefore, the condition existed 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 ₹ 3 lakhs should be made to cover the loss arising due to the bankruptcy of the debtor in the financial statements for the year ended 31st March, 2023.
- iv. 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 is a non-adjusting event. 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, D Limited should value the investments at ₹ 35 lakhs as on 31st March, 2023.
- v. As per Ind AS 10, an entity should adjust the financial statements for the events that occurred after the reporting period, but before the financial statements are approved for issue, if those events provide evidence of conditions that existed at the end of the reporting period.
- In this case, negotiations continued with Varun Limited to acquire land from 1st December, 2022 till first week of April, 2023. Since on the reporting date, the condition was only on proposal state and transaction was completed on 1st week of April 2023, the event will be considered as a non-adjusting event as per Ind AS 10. Purchase of land should be recognized in the financial year 2023-2024. However, the same may be disclosed in the Notes to Accounts for due information to the users of the financial statements.

IND AS 12 – INCOME TAXES

Illustration 1

The directors of H wish to recognise a material deferred tax asset in relation to ₹ 250 Cr of unused trading losses which have accumulated as at 31st March 20X1. H has budgeted profits for ₹ 80 Cr for the year ended 31st March 20X2. The directors have forecast that profits will grow by 20% each year thereafter. However, the improvement in trading results may occur after the next couple of years to come at the position of breakeven. The market is currently depressed and sales orders are at a lower level for the first quarter of 20X2 than they were for the same period in any of the previous five years. H operates under a tax jurisdiction which allows for trading losses to be only carried forward for a maximum of two years.

Analyse whether a deferred tax asset can be recognized in the financial statements of H for the year ended 31st March 20X1?

Solution:

In relation to unused trading losses, the carrying amount is zero since the losses have not yet been recognised in the financial statements of H. A potential deferred tax asset does arise but the determination of the tax base is more problematic.

The tax base of an asset is the amount which will be deductible against taxable economic benefits from recovering the carrying amount of the asset. Where recovery of an asset will have no tax consequences, the tax base is equal to the carrying amount. H operates under a tax jurisdiction which only allows losses to be carried forward for two years. The maximum the tax base could be is therefore equal to the amount of unused losses for years 20X0 and 20X1 since these only are available to be deducted from future profits. The tax base though needs to be restricted to the extent that there is a probability of sufficient future profits to offset the trading losses. The directors of H should base their forecast of the future profitability on reasonable and supportable assumptions. There appears to be evidence that this is not the case.

H has accumulated trading losses and there is little evidence that there will be an improvement in trading results within the next couple of years. The market is depressed and sales orders for the first quarter of 20X2 are below levels in any of the previous five years.

The forecast profitability for 20X2 and subsequent growth rate therefore appear to be unrealistically optimistic.

Given that losses can only be carried forward for a maximum of two years, it is unlikely that any deferred tax asset should be recognised.

Hence, the contention of directors to recognized deferred tax assets in relation to ₹250 crores is not correct.

Illustration 2

On 1st April 20X1, S Ltd. leased a machine over a 5 year period. The present value of lease liability is ₹ 120 Cr (discount rate of 8%) and is recognized as lease liability and corresponding Right of Use (RoU) Asset on the same date. The RoU Asset is depreciated under straight line method over the 5 years. The annual lease rentals are ₹ 30 Cr payable starting 31st March 20X2. The tax law permits tax deduction on the basis of payment of rent.

Assuming tax rate of 30%, you are required to explain the deferred tax consequences for the above transaction for the year ended 31st March 20X2.

Solution:

A temporary difference effectively arises between the value of the machine for accounting purposes and the amount of lease liability, since the rent payment is eligible for tax deduction.

Tax base of the machine is nil as the amount is not eligible for deduction for tax purposes.

Tax base of the lease liability is nil as it is measured at carrying amount less any future tax deductible amount

Recognition of deferred tax on 31st March 20X2:

Carrying amount in balance sheet

RoU Asset (120 Cr – 24 Cr (Depreciation))	₹ 96.00 Dr
Lease Liability (120 Cr + 9.60 Cr (120 Cr x 8%) - 30 Cr)	₹ 99.60 Cr
Net Amount	₹ 3.60 Cr
Tax Base	₹ 0.00 Cr
Temporary Difference (deductible)	₹ 3.60 Cr
Deferred Tax asset to be recognized (₹ 3.60 Cr x 30%)	₹ 1.08 Cr

Illustration 3 – (MTP Oct'21)

On 1 April 20X1, A Ltd. acquired 12 Cr shares (representing 80% stake) in B Ltd. by means of a cash payment of ₹ 25 Cr. It is the group policy to value the non-controlling interest in subsidiaries at the date of acquisition at fair value. The market value of an equity share in B Ltd. at 1 April 20X1 can be used for this purpose. On 1 April 20X1, the market value of a B Ltd. share was ₹ 2.00

On 1 April 20X1, the individual financial statements of B Ltd. showed the net assets at ₹ 23 Cr.

The directors of A Ltd. carried out a fair value exercise to measure the identifiable assets and liabilities of B Ltd. at 1 April 20X1. The following matters emerged:

- Property having a carrying value of ₹ 15 Cr at 1 April 20X1 had an estimated market value of ₹ 18 Cr at that date.
- Plant and equipment having a carrying value of ₹ 11 Cr at 1 April 20X1 had an estimated market value of ₹ 13 Cr at that date.
- Inventory in the books of B Ltd. is shown at a cost of ₹ 2.50 Cr. The fair value of the inventory on the acquisition date is ₹ 3 Cr.

The fair value adjustments have not been reflected in the individual financial statements of B Ltd. In the consolidated financial statements, the fair value adjustments will be regarded as temporary differences for the purposes of computing deferred tax. The rate of deferred tax to apply to temporary differences is 20%.

Calculate the deferred tax impact on above and calculate the goodwill arising on acquisition of B Ltd.

(6 Marks)**Solution:**

Purchase Consideration:	₹ 25 Cr
Non-Controlling Interest [$\{ \{ (12 \text{ Cr} \times (20\% / 80\%)) \} \times ₹ 2 \text{ per share} \}$]	₹ 6 Cr

Computation of Net Assets of B Ltd.

As per books	₹ 23.00 Cr
Add: Fair value differences not recognized in books of B Ltd.:	
Property (18 Cr – 15 Cr)	₹ 3.00 Cr
Plant and Equipment (13 Cr – 11 Cr)	₹ 2.00 Cr
Inventory (3 Cr – 2.5 Cr)	₹ 0.50 Cr
	₹ 28.5 Cr
Less: Deferred tax liability on fair value difference @ 20%	
$[(3 \text{ Cr} + 2 \text{ Cr} + 0.50 \text{ Cr}) \times 20\%]$	(₹ 1.10 Cr)
Total Net Assets at Fair Value	₹ 27.40 Cr

Computation of Goodwill:

Purchase Consideration	₹ 25.00 Cr
Add: Non-Controlling Interest	₹ 6.00 Cr
	₹ 31.00 Cr
Less: Net Assets at Fair Value	(₹ 27.40 Cr)
Goodwill on acquisition date	₹ 3.60 Cr

Illustration 4

On 1st April 20X1, P Ltd. had granted 1 Cr share options worth ₹ 4 Cr subject to a two-year vesting period. The income tax law permits a tax deduction at the exercise date of the intrinsic value of the options. The intrinsic value of the options at 31st March 20X2 was ₹ 1.60 Cr and at 31st March 20X3 was ₹ 4.60 Cr. The increase in the fair value of the options on 31st March 20X3 was not foreseeable at 31st March 20X2. The options were exercised at 31st March 20X3.

Give the accounting for the above transaction for deferred tax for period ending 31st March, 20X2 and 31st March, 20X3. Assume that there are sufficient taxable profits available in future against any deferred tax assets. Tax rate of 30% is applicable to P Ltd.

Solution:

On 31st March 20X2:

The tax benefit is calculated as under:

Carrying amount of Share based payment	₹ 0.00 Cr
Tax Base of Share based payment ($₹ 1.60 \text{ Cr} \times \frac{1}{2}$)	₹ 0.80 Cr
Temporary Difference (Carrying amount – tax base)	₹ 0.80 Cr
Deferred Tax Asset recognized (Temporary Difference x Tax rate)	
($0.80 \text{ Cr} \times 30\%$)	₹ 0.24 Cr

Journal Entry for above:

Deferred Tax Asset	Dr.	₹ 0.24 Cr
To Tax Expense		₹ 0.24 Cr

(Being DTA recognized on equity option)

On 31st March 20X3:

The options have been exercised and a current tax benefit will be available to the entity on the basis of intrinsic value of ₹ 4.60 Cr. Initially recognized deferred tax asset will no longer be required.

The accounting entry will be done as under:

Tax Expense	Dr.	₹ 0.24 Cr
To Deferred Tax Asset		₹ 0.24 Cr

(Being DTA reversed on the exercise of the option)

Illustration 5 – (RTP May'18, MTP Oct'21)

A's Ltd. profit before tax according to Ind AS for Year 20X1-20X2 is ₹ 100 thousand and taxable profit for year 20X1-20X2 is ₹ 104 thousand. The difference between these amounts arose as follows:

- On 1st February, 20X2, it acquired a machine for ₹ 120 thousand. Depreciation is charged on the machine on a monthly basis for accounting purpose. Under the tax law, the machine will be depreciated for 6 months. The machine's useful life is 10 years according to Ind AS as well as for tax purposes.
- In the year 20X1-20X2, expenses of ₹ 8 thousand were incurred for charitable donations. These are not deductible for tax purposes.

Prepare necessary entries as at 31st March 20X2, taking current and deferred tax into account. The tax rate is 25%. Also prepare the tax reconciliation in absolute numbers as well as the tax rate reconciliation.

(8 Marks)

Solution:

Current tax = Taxable profit x Tax rate = ₹104 thousand x 25% = ₹26 thousand.

Computation of Taxable Profit:

	₹ in thousand
Accounting profit	100
Add: Donation not deductible	8
Less: Excess Depreciation	(4)
Total Taxable profit	104

	₹ in thousand	₹ in thousand
Profit & loss A/c Dr.	26	
To Current Tax		26

Deferred tax:

Machine's carrying amount according to Ind AS is ₹ 118 thousand (₹ 120 thousand – ₹ 2 thousand)

Machine's carrying amount for taxation purpose = ₹ 114 thousand (₹ 120 thousand – ₹ 6 thousand)

Deferred Tax Liability = ₹ 4 thousand x 25%

	₹ in thousand
Profit & loss A/c Dr.	1
To Deferred Tax Liability	1

Tax reconciliation in absolute numbers:

	₹ in thousand
Profit before tax according to Ind AS	100
Applicable tax rate	25%
Tax	25
Expenses not deductible for tax purposes (₹ 8 thousand x 25%)	2
Tax expense (Current and deferred)	27

Tax rate reconciliation

Applicable tax rate	25%
Expenses not deductible for tax purposes	2%
Average effective tax rate	27%

Illustration 6

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.

Illustration 7

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 February 28, 20X2, the finance bill is introduced in the legislation that changes the tax rate to 30%. The finance bill is enacted as Act on May 21, 20X2.

Discuss the treatment of deferred tax in case the reporting date of A Limited's financial statement is December 31, 20X1 and these are approved for issued on May 31, 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.

Illustration 8 (MTP Nov'23)

A Ltd prepares financial statements to 31 March each year. The rate of income tax applicable to A Ltd is 20%. The following information relates to transactions, assets and liabilities of A Ltd during the year ended 31 March 20X2:

- i) A Ltd has a 40% shareholding in L Ltd. A Ltd purchased this shareholding for ₹ 45 Cr. The shareholding gives A Ltd significant influence over L Ltd but not control and therefore A Ltd. accounts for its interest in L Ltd using the equity method. The equity method carrying value of A Ltd's investment in L Ltd was ₹ 70 Cr on 31 March 20X1 and ₹ 75 Cr on 31 March 20X2. In the tax jurisdiction in which A Ltd operates, profits recognised under the equity method are taxed if and when they are distributed as a dividend or the relevant investment is disposed of.
- ii) A Ltd. measures its head office building using the revaluation model. The building is revalued every year on 31 March. On 31 March 20X1, carrying value of the building (after revaluation) was ₹ 40 Cr and its tax base was ₹ 22 Cr. During the year ended 31 March 20X2, A Ltd charged depreciation in its statement of profit or loss of ₹ 2 Cr and claimed a tax deduction for tax depreciation of ₹ 1.25 Cr. On 31 March 20X2, the building was revalued to ₹ 45 Cr. In the tax jurisdiction in which A Ltd operates, revaluation of property, plant and equipment does not affect taxable income at the time of revaluation.

Basis the above information, you are required to compute:

- a) The deferred tax liability of A Ltd at 31 March 20X2
- b) The charge or credit to both profit or loss and other comprehensive income relating to deferred tax for the year ended 31 March 20X2 (10 Marks)

Solution:**(A) Deferred Tax Liability as at 31st March 20X2****Investment in L Ltd:**

Carrying Amount	=	₹ 75 Cr
Tax base	=	₹ 45 Cr (Purchase cost)
Temporary Difference	=	₹ 30 Cr

Since carrying amount is higher than the tax base, the temporary difference is recognized as a taxable temporary difference. Using the tax rate of 20%, a deferred tax liability of ₹ 6 Cr is recognized:

Head office building

Carrying Amount = ₹ 45 Cr

(Revalued amount on 31st of March 20X2)

Tax base = ₹ 20.75 Cr (22 Cr – 1.25 Cr)

Temporary Difference = ₹ 24.25 Cr

Since carrying amount is higher than the tax base, the temporary difference is recognized as a taxable temporary difference. Using the tax rate of 20%, a deferred tax liability of ₹ 4.85 Cr is created.

Total Deferred Tax Liability ₹ 6 Cr + ₹ 4.85 Cr = ₹ 10.85 Cr

(B) Charge to Statement of Profit or Loss for the year ended 31st March 20X2:**Investment in L Ltd.**

Particulars	Carrying amount	Tax Base	Temporary Difference
Opening Balance (1st April 20X1)	₹ 70 Cr	₹ 45 Cr	₹ 25 Cr
Closing Balance (31st March 20X2)	₹ 75 Cr	₹ 45 Cr	₹ 30 Cr
Net Change			₹ 5 Cr
Increase in Deferred Tax Liability (20% tax rate)			₹ 1 Cr

Considering the increase in the value of investment arising through Statement of Profit or Loss, the accounting for the increase in deferred tax liability is made as under:

Tax expense (Profit or Loss Statement) Dr ₹ 1 Cr
 To Deferred Tax Liability ₹ 1 Cr

(Being increase in deferred tax liability recognized)

Head Office Building:

The deferred tax liability at 31 March 20X1 is ₹ 3.6 Cr (20% x {₹ 40 Cr – ₹ 22 Cr}).

At 31 March 20X2, prior to revaluation, the carrying amount of the property is ₹ 38 Cr and its tax base is ₹ 20.75 Cr (₹ 22 Cr – ₹ 1.25 Cr). The deferred tax liability at this point is ₹ 3.45 Cr (20% x {₹ 38 Cr – ₹ 20.75 Cr}).

The reduction in this liability is ₹ 0.15 Cr (₹ 3.6 Cr – ₹ 3.45 Cr). This would be credited to income tax expense in arriving at profit or loss.

Post revaluation, the carrying value of the building becomes ₹ 45 Cr and the tax base stays the same. Therefore, the new deferred tax liability is ₹ 4.85 Cr (20% x {₹ 45 Cr – ₹ 20.75 Cr}). The increase in the deferred tax liability of ₹ 1.4 Cr (₹ 4.85 Cr – ₹ 3.45 Cr) is charged to other comprehensive income.

Illustration 9 – (MTP Nov'22)

K Ltd prepares consolidated financial statements to 31st March each year. During the year ended 31st March 20X2, K Ltd entered into the following transactions:

- On 1st April 20X1, K Ltd purchased an equity investment for ₹ 2,00,000. The investment was designated as fair value through other comprehensive income. On 31st March 20X2, the fair value of the investment was ₹ 2,40,000. In the tax jurisdiction in which K Ltd operates, unrealised gains and losses arising on the revaluation of investments of this nature are not taxable unless the investment is sold. K Ltd has no intention of selling the investment in the foreseeable future.
- On 1st August 20X1, K Ltd sold products to A Ltd, a wholly owned subsidiary operating in the same tax jurisdiction as K Ltd, for ₹ 80,000. The goods had cost to K Ltd for ₹ 64,000. By 31st March 20X2, A Ltd had sold 40% of these goods, selling the remaining during next year.
- On 31st October 20X1, K Ltd received ₹ 2,00,000 from a customer. This payment was in respect of services to be provided by K Ltd from 1st November 20X1 to 31st July 20X2. K Ltd recognised revenue

of ₹ 1,20,000 in respect of this transaction in the year ended 31st March 20X2 and will recognise the remainder in the year ended 31st March 20X3. Under the tax jurisdiction in which K Ltd operates, ₹ 2,00,000 received on 31st October 20X1 was included in the taxable profits of K Ltd for the year ended 31st March 20X2.

Explain and show how the tax consequences (current and deferred) of the three transactions would be reported in its statement of profit or loss and other comprehensive income for the year ended 31st March 20X2. Assume tax rate to be 25%. (6 Marks)

Solution:

- a) Because the unrealised gain on revaluation of the equity investment is not taxable until sold, there are no current tax consequences. The tax base of the investment is ₹ 2,00,000. The revaluation creates a taxable temporary difference of ₹ 40,000 (₹ 2,40,000 – ₹ 2,00,000).

This creates a deferred tax liability of ₹ 10,000 (₹ 40,000 x 25%). The liability would be non-current. The fact that there is no intention to dispose of the investment does not affect the accounting treatment. Because the unrealised gain is reported in other comprehensive income, the related deferred tax expense is also reported in other comprehensive income.

- b) When K Ltd sold the products to A Ltd, K Ltd would have generated a taxable profit of ₹ 16,000 (₹ 80,000 – ₹ 64,000). This would have created a current tax liability for K Ltd and the group of ₹ 4,000 (₹ 16,000 x 25%). This liability would be shown as a current liability and charged as an expense in arriving at profit or loss for the period.

In the consolidated financial statements the carrying value of the unsold inventory would be ₹ 38,400 (₹ 64,000 x 60%). The tax base of the unsold inventory would be ₹ 48,000 (₹ 80,000 x 60%). In the consolidated financial statements there would be a deductible temporary difference of ₹ 9,600 (₹ 38,400 – ₹ 48,000) and a potential deferred tax asset of ₹ 2,400 (₹ 9,600 x 25%). This would be recognised as a deferred tax asset since A Ltd is expected to generate sufficient taxable profits against which to utilise the deductible temporary difference. The resulting credit would reduce consolidated deferred tax expense in arriving at profit or loss.

- c) The receipt of revenue in advance on 1st October 20X1 would create a current tax liability of ₹ 50,000 (₹ 200,000 x 25%) as at 31st March 20X2. The carrying value of the revenue received in advance at 31st March 20X2 is ₹ 80,000 (₹ 200,000 – ₹ 120,000). Its tax base is nil. The deductible temporary difference of ₹ 80,000 would create a deferred tax asset of ₹ 20,000 (₹ 80,000 x 25%). The asset can be recognised because K Ltd has sufficient taxable profits against which to utilise the deductible temporary difference.

Illustration 10

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 and the corresponding deferred tax or liability, if any

Solution

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.

Illustration 11

On 1st April 20X1, ABC Ltd acquired 100% shares of XYZ Ltd for INR 4,373 crores. By 31st March, 20X5, XYZ Ltd had made profits of INR 5 crores, 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%. Show deferred tax treatment

Solution

A taxable temporary difference of INR 5 therefore exists between the carrying value of the investment in XYZ at the reporting date of INR 4,378 (INR 4,373 + INR 5) and its tax base of INR 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.

Illustration 12

ABC Ltd. acquired 50% of the shares in PQR Ltd. on 1st January 20X1 for INR 1000 crores. By 31st March, 20X5 PQR Ltd. had made profits of INR 50 crores (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%. Show deferred tax treatment.

Solution

A taxable temporary difference of INR 50 therefore exists between the carrying value of the investment in PQR at the reporting date of INR 1,050 (INR 1,000 + INR 50) and its tax base of INR 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%).

Illustration 13

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.

Solution

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

Illustration 14 (Past Exam Jan'21)

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)

Assume tax rate as 30%.

Calculate deferred tax asset assuming that the carrying amount is the tax base and prepare the journal entries (5 Marks)

Solution

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

Illustration 15 (Past Exam – Dec 2021)

B Limited is a newly incorporated entity. Its first financial period ends on March 31, 20X1. As on the said date, the following temporary differences exist:

- Taxable temporary differences relating to accelerated depreciation of ₹9,000. These are expected to reverse equally over next 3 years.
- Deductible temporary differences relating to preliminary expenses 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 March 31, 20X1.

(5 Marks)

Solution

The year-wise anticipated reversal of temporary differences is as under:

Particulars	Year ending on	Year ending on	Year ending on	Year ending on

	March 31,20X2	March 31,20X3	March 31,20X4	March 31,20X5
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 March 31, 20 X4 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 March 31, 20 X5 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 March 31, 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.

Illustration 16 - (RTP – Nov 2018)

X Ltd. prepares consolidated financial statements to 31st March each year. During the year ended 31st March 2018, the following events affected the tax position of the group:

(i) Y Ltd., a wholly owned subsidiary of X Ltd., made a loss adjusted for tax purposes of ₹ 30,00,000. Y Ltd. is unable to utilise this loss against previous tax liabilities. Income-tax Act does not allow Y Ltd. to transfer the tax loss to other group companies. However, it allows Y Ltd. to carry the loss forward and utilise it against company's future taxable profits. The directors of X Ltd. do not consider that Y Ltd. will make taxable profits in the foreseeable future.

(ii) Just before 31st March, 2018, X Ltd. committed itself to closing a division after the year end, making a number of employees redundant. Therefore X Ltd. recognised a provision for closure costs of ₹ 20,00,000 in its statement of financial position as at 31st March, 2018. Income-tax Act allows tax deductions for closure costs only when the closure actually takes place. In the year ended 31 March 2019, X Ltd. expects to make taxable profits which are well in excess of ₹ 20,00,000. On 31st March, 2018, X Ltd. had taxable temporary differences from other sources which were greater than ₹ 20,00,000.

(iii) During the year ended 31 March 2017, X Ltd. capitalised development costs which satisfied the criteria in paragraph 57 of Ind AS 38 'Intangible Assets'. The total amount capitalised was ₹ 16,00,000. The development project began to generate economic benefits for X Ltd. from 1st January 2018. The directors of X Ltd. estimated that the project would generate economic benefits for five years from that date. The development expenditure was fully deductible against taxable profits for the year ended 31 March 2018.

(iv) On 1 April 2017, X Ltd. borrowed ₹ 1,00,00,000. The cost to X Ltd. of arranging the borrowing was ₹ 2,00,000 and this cost qualified for a tax deduction on 1 April 2017. The loan was for a three-year period. No interest was payable on the loan but the amount repayable on 31 March 2020 will be ₹ 1,30,43,800. This equates to an effective annual interest rate of 10%. As per the Income-tax Act, a further tax deduction of ₹ 30,43,800 will be claimable when the loan is repaid on 31st March, 2020.

Explain and show how each of these events would affect the deferred tax assets / liabilities in the consolidated balance sheet of X Ltd. group at 31 March, 2018 as per Ind AS. Assume the rate of corporate income tax is 20%.

Solution

(i) The tax loss creates a potential deferred tax asset for the group since its carrying value is nil and its tax base is ₹ 30,00,000.

However, no deferred tax asset can be recognised because there is no prospect of being able to reduce tax liabilities in the foreseeable future as no taxable profits are anticipated.

(ii) The provision creates a potential deferred tax asset for the group since its carrying value is ₹ 20,00,000 and its tax base is nil.

This deferred tax asset can be recognised because X Ltd. is expected to generate taxable profits in excess of ₹ 20,00,000 in the year to 31st March, 2019.

The amount of the deferred tax asset will be ₹ 4,00,000 ($₹ 20,00,000 \times 20\%$).

This asset will be presented as a deduction from the deferred tax liabilities caused by the (larger) taxable temporary differences.

(iii) The development costs have a carrying value of ₹ 15,20,000 ($₹ 16,00,000 - (₹ 16,00,000 \times 1/5 \times 3/12)$).

The tax base of the development costs is nil since the relevant tax deduction has already been claimed.

The deferred tax liability will be ₹ 3,04,000 ($₹ 15,20,000 \times 20\%$). All deferred tax liabilities are shown as non-current.

(iv) The carrying value of the loan at 31st March, 2018 is ₹ 1,07,80,000 ($₹ 1,00,00,000 - ₹ 2,00,000 + (₹ 98,00,000 \times 10\%)$).

The tax base of the loan is ₹ 1,00,00,000.

This creates a deductible temporary difference of ₹ 7,80,000 ($₹ 1,07,80,000 - ₹ 1,00,00,000$) and a potential deferred tax asset of ₹ 1,56,000 ($₹ 7,80,000 \times 20\%$).

Due to the availability of taxable profits next year (see part (ii) above), this asset can be recognised as a deduction from deferred tax liabilities.

Illustration 17 (RTP May'19) (MTP May'24)

PQR Ltd. a manufacturing company, prepares consolidated financial statements to 31st March each year. During the year ended 31st March, 2018, the following events affected the tax position of the group:

- QPR Ltd., a wholly owned subsidiary of PQR Ltd., incurred a loss adjusted for tax purposes of ₹ 30,00,000. QPR Ltd. is unable to utilise this loss against previous tax liabilities. Income-tax Act does not allow QPR Ltd. to transfer the tax loss to other group companies. However, it allows QPR Ltd. to carry the loss forward and utilise it against company's future taxable profits. The directors of PQR Ltd. do not consider that QPR Ltd. will make taxable profits in the foreseeable future.
- During the year ended 31st March, 2018, PQR Ltd. Capitalised development costs which satisfied the criteria as per Ind AS 38 'Intangible Assets'. The total amount capitalised was 16,00,000. The development project began to generate economic benefits for PQR Ltd. from 1st January, 2018. The directors of PQR Ltd. estimated that the project would generate economic benefits for five years from that date. The development expenditure was fully deductible against taxable profits for the year ended 31st March, 2018.
- On 1st April, 2017, PQR Ltd. borrowed 1,00,00,000. The cost to PQR Ltd. of arranging the borrowing was 2,00,000 and this cost qualified for a tax deduction on 1st April 2017. The loan was for a three-year period. No interest was payable on the loan but the amount repayable on 31st March 2020 will be 1,30,43,800. This equates to an effective annual interest rate of 10%. As per the Income-tax Act, a further tax deduction of 30,43,800 will be claimable when the loan is repaid on 31st March, 2020.

Explain and show how each of these events would affect the deferred tax assets / liabilities in the consolidated balance sheet of PQR Ltd. group at 31st March, 2018 as per Ind AS. The rate of corporate income tax is 30%.
(5 Marks)

Solution

Impact on consolidated balance sheet of PQR Ltd. group at 31st March, 2018

- The tax loss creates a potential deferred tax asset for the PQR Ltd. group since its carrying value is nil and its tax base is 30,00,000. However, no deferred tax asset can be recognised because there is no prospect of being able to reduce tax liabilities in the foreseeable future as no taxable profits are anticipated.
- The development costs have a carrying value of 15,20,000 ($16,00,000 - (16,00,000 \times 1/5 \times 3/12)$). The tax base of the development costs is nil since the relevant tax deduction has already been

claimed. The deferred tax liability will be 4,56,000 ($15,20,000 \times 30\%$). All deferred tax liabilities are shown as non-current.

- The carrying value of the loan at 31st March, 2018 is 1,07,80,000 ($1,00,00,000 - 200,000 + (98,00,000 \times 10\%)$). The tax base of the loan is 1,00,00,000. This creates a deductible temporary difference of 7,80,000 and a potential deferred tax asset of ₹ 2,34,000 ($7,80,000 \times 30\%$).

Illustration 18

An entity is finalising its financial statements for the year ended 31st March, 20X2. Before 31st March, 20X2, the government announced that the tax rate was to be amended from 40 per cent to 45 per cent of taxable profit from 30th June, 20X2.

The legislation to amend the tax rate has not yet been approved by the legislature. However, the government has a significant majority and it is usual, in the tax jurisdiction concerned, to regard an announcement of a change in the tax rate as having the substantive effect of actual enactment (i.e. It is substantively enacted).

After performing the income tax calculations at the rate of 40 per cent, the entity has the following deferred tax asset and deferred tax liability balances:

Deferred tax asset	₹ 80,000
Deferred tax liability	₹ 60,000

Of the deferred tax asset balance, ₹ 28,000 related to a temporary difference. This deferred tax asset had previously been recognised in OCI and accumulated in equity as a revaluation surplus.

The entity reviewed the carrying amount of the asset in accordance with para 56 of Ind AS 12 and determined that it was probable that sufficient taxable profit to allow utilisation of the deferred tax asset would be available in the future.

Show the revised amount of Deferred tax asset & Deferred tax liability and present the necessary journal entries.

Solution:

Calculation of Deductible temporary differences:

$$\begin{aligned} \text{Deferred tax asset} &= ₹ 80,000 \\ \text{Existing tax rate} &= 40\% \\ \text{Deductible temporary differences} &= 80,000 / 40\% \\ &= ₹ 2,00,000 \end{aligned}$$

Calculation of Taxable temporary differences:

$$\begin{aligned} \text{Deferred tax liability} &= ₹ 60,000 \\ \text{Existing tax rate} &= 40\% \\ \text{Deductible temporary differences} &= 60,000 / 40\% \\ &= ₹ 1,50,000 \end{aligned}$$

Of the total deferred tax asset balance of ₹ 80,000, ₹ 28,000 is recognized in OCI

Hence, Deferred tax asset balance of Profit & Loss is ₹ 80,000 - ₹ 28,000 = ₹ 52,000

Deductible temporary difference recognized in Profit & Loss is ₹ 1,30,000 ($52,000 / 40\%$)

Deductible temporary difference recognized in OCI is ₹ 70,000 ($28,000 / 40\%$)

The adjusted balances of the deferred tax accounts under the new tax rate are:

Deferred tax asset		₹
Previously credited to OCI-equity	₹ 70,000 x 0.45	31,500
Previously recognised as Income	₹ 1,30,000 x 0.45	58,500

Deferred tax liability		<u>90,000</u>
Previously recognized as expense	₹ 1,50,000 x 0.45	67,500

The net adjustment to deferred tax expense is a reduction of ₹ 2,500. Of this amount, ₹ 3,500 is recognised in OCI and ₹ 1,000 is charged to P&L.

The amounts are calculated as follows:

	Carrying amount at 45%	Carrying amount at 40%	Increase (decrease) in deferred tax expense
Deferred tax assets			
Previously credited to OCI-equity	31,500	28,000	(3,500)
Previously recognised as Income	<u>58,500</u>	<u>52,000</u>	<u>(6,500)</u>
	90,000	80,000	(10,000)
Deferred tax liability			
Previously recognized as expense	67,500	60,000	<u>7,500</u>
Net adjustment			<u>(2,500)</u>

An alternative method of calculation is:		₹
DTA shown in OCI	₹ 70,000 x (0.45 - 0.40)	3,500
DTA shown in Profit or Loss	₹ 1,30,000 x (0.45-0.40)	6,500
DTL shown in Profit or Loss	₹ 1,50,000 x (0.45 -0.40)	7,500

Journal Entries

	₹	₹
Deferred tax asset	3,500	
OCI –revaluation surplus		3,500
Deferred tax asset	6,500	
Deferred tax expense		6,500
Deferred tax expense	7,500	
Deferred tax liability		7,500

Alternatively, a combined journal entry may be passed as follows:

	₹	₹
Deferred tax asset Dr.	10,000	
Deferred tax expense Dr.	1,000	
To OCI –revaluation surplus		3,500
To Deferred tax liability		7,500

Illustration 19 - (RTP - Nov 2020)

On 1 January 2020, entity H acquired 100% share capital of entity S for ₹15,00,000. The book values and the fair values of the identifiable assets and liabilities of entity S at the date of acquisition are set out below, together with their tax bases in entity S's tax jurisdictions. Any goodwill arising on the acquisition is not deductible for tax purposes. The tax rates in entity H's and entity S's jurisdictions are 30% and 40% respectively.

Acquisitions	₹Book values ₹'000	Tax base ₹'000	Fair values ₹'000
Land and buildings	600	500	700
Property, plant and equipment	250	200	270

Inventory	100	100	80
Accounts receivable	150	150	150
Cash and cash equivalents	130	130	130
Accounts payable	(160)	(160)	(160)
Retirement benefit obligations	(100)	-	(100)

You are required to calculate the deferred tax arising on acquisition of Entity S. Also calculate the Goodwill arising on acquisition.

Solution

Calculation of Net assets acquired (excluding the effect of deferred tax liability):

Net assets acquired	Tax base ₹'000	Fair values ₹'000
Land and buildings	500	700
Property, plant and equipment	200	270
Inventory	100	80
Accounts receivable	150	150
Cash and cash equivalents	130	130
Total assets	1,080	1,330
Accounts payable	(160)	(160)
Retirement benefit obligations	-	(100)
Net assets before deferred tax liability	920	1,070

Calculation of deferred tax arising on acquisition of entity S and goodwill

	₹'000	₹'000
Fair values of S's identifiable assets and liabilities (excluding deferred tax)		1,070
Less: Tax base		(920)
Temporary difference arising on acquisition		150
Net deferred tax liability arising on acquisition of entity S (₹150,000 @ 40%)		60
Purchase consideration		1,500
Less: Fair values of entity S's identifiable assets and liabilities (excluding deferred tax)	1,070	
Deferred tax liability	(60)	(1,010)
Goodwill arising on acquisition		490

Note: Since, the tax base of the goodwill is nil, taxable temporary difference of ₹4,90,000 arises on goodwill. However, no deferred tax is recognised on the goodwill. The deferred tax on other temporary differences arising on acquisition is provided at 40% and not 30%, because taxes will be payable or recoverable in entity S's tax jurisdictions when the temporary differences will be reversed.

Illustration 20 A

H Ltd. is a manufacturing company, wanting to calculate its taxable profit or loss for the year ended 31 March 20X8. The statement of profit and loss and other comprehensive income, the balance sheet and the notes are given below.

Tax rate for the financial year 20X7-20X8 is 30%, but the new tax rate of 32%, for the year 20X8-20X9 and beyond, has already been enacted before the year end.

Calculate taxable profit for the financial year 20X7-20X8 and the related current tax expense.

Balance Sheet as of 31 March 20X8

	₹
ASSETS	
Non-current assets	
Property, plant and equipment	4,20,00,000
Product development costs	21,00,000
Investment in subsidiary – S Ltd.	1,54,00,000
Current assets	
Trading investments	72,80,000
Trade receivables	2,19,10,000
Inventories	1,06,40,000
Cash and cash equivalents	63,00,000
TOTAL ASSETS	10,56,30,000
EQUITY & LIABILITIES	
Equity	
Share capital	4,20,00,000
Accumulated profits	2,86,24,330
Revaluation surplus	30,80,000
Non-current liabilities	
Deferred income - government grants	14,00,000
Liability for product warranty costs	5,60,000
Deferred tax liability (from 20X6-20X7)	7,75,670
Current liabilities	
Trade payables	2,67,40,000
Medical benefits for employees	24,50,000
TOTAL EQUITY & LIABILITIES	10,56,30,000

Extract of Statement of profit and loss for the year ended 31 March 20X8

Revenue	16,81,40,000
Cost of sales	(13,44,00,000)
Gross profit	3,37,40,000
Operating costs	(2,68,80,000)
Profit from operations	68,60,000
Finance costs	(9,10,000)
Profit before taxation	59,50,000

Notes:

1. Depreciation expense for the year financial year 20X7-20X8 allowable as per the Income Tax Rules is ₹ 72,10,000. Depreciation as allowed for the purposes of financial reporting included in operating costs is ₹ 59,50,000. Cost of PPE is ₹ 5,60,00,000 and H Ltd. deducted expenses of ₹ 1,45,60,000 in its tax returns prior to financial year 20X7-20X8. Further, as of 31 March 20X8, H Ltd. for the first time revalued its property, plant and equipment to market value of ₹ 4,20,00,000 (revaluation surplus = ₹ 30,80,000).
2. In 20X4-20X5, H Ltd. incurred product development costs of ₹ 35,00,000. These costs were recognized as an asset and amortized over period of 10 years. For tax purposes, H Ltd. deducted full product development costs when they were in 20X4-20X5.
3. Trading investments were acquired in the preceding year at a cost of ₹ 80,50,000. These investments are classified as at fair value through profit or loss and thus recognized in their fair value. Fair value adjustments are not allowable by the tax authorities.
4. Bad debt provision amounts to ₹ 45,50,000 and relates to 2 debtors: debtor A – ₹ 28,00,000 (receivable originates in 20X5-20X6 and 100% provision was recognized in the preceding year) and debtor B – ₹ 17,50,000 (receivable originates in 20X6-20X7 and 100% provision was recognized in F.Y. 20X7-20X8). Tax law allows deduction of 20% of provision for debtors overdue for more than 1 year, another 30% for debtors overdue for more than 2 years and remaining 50% for debtors overdue for more than 3 years.
5. H Ltd. created a provision for inventory obsolescence in accordance with Ind AS 2 requirements. New provision created in 20X7-20X8 was ₹ 3,78,000 (total provision: ₹ 6,30,000). Being a general provision, this provision is not tax deductible.
6. Government grants are not taxable. Full government grant received in 20X7-20X8 is included in the balance sheet.
7. In 20X7-20X8, H Ltd. increased a liability for product warranty costs by ₹ 1,75,000. Product warranty costs are not tax deductible until the company pays claims. Claims paid in 20X7-20X8 amounted to ₹ 2,17,000.
8. During the year, H Ltd. introduced health care benefits for employees. The expenses are allowable for tax purposes only when benefits are paid but in line with Ind AS 19, recognized in profit or loss when employees provide service.
9. Penalties towards violation of laws included in operating expenses amount to ₹ 63,000. These are not deductible for tax purposes.
10. Tax law allows to deduct expenses for petrol only up to ₹ 1,40,000 per vehicle per year. H Ltd. had 4 vehicles in 20X7-20X8 and its total petrol expenses amounted to ₹ 7,21,000.

Note: This illustration is prepared for the purposes of understanding the computation of current tax and is in no way based on the provisions of the Income Tax Act, 1961. For the purposes of Financial Reporting, the tax treatments will be given in the question.

Solution:

Calculation of current tax expense

Accounting profit	(A)	59,50,000
Add back:		
Accounting depreciation		59,50,000
Amortization of product development costs (W.N.1)		3,50,000
Revaluation of trading investments		7,70,000
Bad debt provisions - 20X7-20X8		17,50,000
Inventory obsolescence provision		3,78,000
Product warranty costs provision - 20X7-20X8		1,75,000
Provision for health care benefit costs		24,50,000
Fines and Penalties disallowed for tax purposes		63,000

Petrol over limit (W.N.3)		1,61,000
Total	(B)	120,47,000
Deduct:		
Tax depreciation		(72,10,000)
Tax allowance for bad debt provisions (W.N.2)		(11,90,000)
Product warranty costs provision - claims paid		(2,17,000)
Total	(C)	(86,17,000)
Taxable profit / loss:	(A+B-C)	93,80,000
Tax rate is 30%		
Current income tax (93,80,000 x 30%)		28,14,000

Journal Entry

Profit or loss - Current income tax expense Dr.	28,14,000	
To Credit Current income tax liabilities		28,14,000

Working Notes:

1. Product development costs:

Annual amortization (35,00,000/ 10) 3,50,000

2. Bad debt provisions:

Debtor A - 28,00,000 from 20X5-20X6

> 2 years - 30% deductible in 20X7-20X8 8,40,000

Debtor B - 17,50,000 from 20X6-20X7

> 1 year - 20% deductible in 20X7-20X8 3,50,000

Total - tax deductible in 20X7-20X8 11,90,000

3. Petrol expenses

Actual expenses 7,21,000

Tax deductible (4 x 140,000) 5,60,000

Excess 1,61,000

Illustration 20 B (in continuation to Illustration 20A): (RTP May'24)

Based on the balance sheet and notes of H Ltd. from previous example, calculate tax base of its assets and liabilities as of 31 March 20X8. Note that balance sheet has been adjusted by current tax expense and liability.

Balance Sheet as of 31 March 20X8

Assets	₹
Non-Current Assets	
Property, Plant & Equipment	420,00,000
Product Development Costs	21,00,000
Investment in subsidiary – S Ltd.	154,00,000
Current Assets	
Trading Investments	72,80,000

Trade Receivables	219,10,000
Inventories	106,40,000
Cash & Cash Equivalent	63,00,000
Total Assets	10,56,30,000
Equity & Liabilities	
Equity	
Share Capital	420,00,000
Accumulated Profits	258,10,330
Revaluation Surplus	30,80,000
Long Term Liabilities	
Deferred Income – Government Grants	14,00,000
Liability for Product warranty costs	5,60,000
Deferred Tax Liability (from 20X6-20X7)	7,75,670
Current Liabilities	
Trade Payables	267,40,000
Medical Benefits for Employees	24,50,000
Current Tax Liability	28,14,000
Total Equity & Liabilities	10,56,30,000

Remaining information are same as per Illustration 20A.

Solution:

Determination of Tax Base

Item	Carrying amount	Tax base
Property, plant and equipment	420,00,000	342,30,000
Product development costs	21,00,000	0
Investment in subsidiary	154,00,000	154,00,000
Trading investments	72,80,000	80,50,000
Trade receivables	219,10,000	247,10,000
Inventories	106,40,000	112,70,000
Cash and cash equivalents	63,00,000	63,00,000
Deferred income - government grants	-14,00,000	0
Liability for product warranty costs	-5,60,000	0
Trade payables	-267,40,000	-267,40,000
Health care benefits for employees	-24,50,000	0

Working Notes:

1. Property, plant and equipment		
Cost	560,00,000	
Less: current tax depreciation	(72,10,000)	

	Less: PY tax depreciation	(145,60,000)	
	Tax base	3,42,30,000	
2.	Trade receivables - bad debt provisions:		
I	Calculation of cost		
	Carrying amount	219,10,000	
	Add back: bad debt provision	45,50,000	
	Cost	2,64,60,000	A
II	Debtor A - 28,00,000 from 20X5-20X6		
	> 1 year - 20% deducted in 20X6-20X7	5,60,000	
	> 2 years - 30% deducted in 20X7-20X8	8,40,000	
	Already deducted for tax:	14,00,000	
III	Debtor B - 17,50,000 from 20X6-20X7		
	> 1 year - 20% deducted in 20X7-20X8	3,50,000	
	Total deducted for tax purposes	17,50,000	B
	Tax base of trade receivables:	2,47,10,000	A-B

Illustration 20C (in continuation to Illustration 20A): (RTP May'24)

Based on the data from above illustration 20A of H Ltd., calculate temporary differences and deferred tax. Note from Illustration 1A: Tax rate for 20X7-20X8 is 30%, but the new tax rate of 32% for the year 20X8-20X9 and beyond has already been enacted before the year end.

Solution:

Calculation of Temporary Differences / Deferred Tax

Item	Carrying amount	Tax base	Temporary difference	Taxable/ deductible	DTA / DTL at 32%
Property, plant and equipment	4,20,00,000	3,42,30,000	77,70,000	taxable	(24,86,400)
Product development costs	21,00,000	0	21,00,000	taxable	(6,72,000)
Investment in subsidiary S Ltd.	1,54,00,000	1,54,00,000	0		0
Trading investments	72,80,000	80,50,000	(7,70,000)	deductible	2,46,400
Trade receivables	2,19,10,000	2,47,10,000	(28,00,000)	deductible	8,96,000
Inventories	1,06,40,000	1,12,70,000	(6,30,000)	deductible	2,01,600
Cash and cash equivalents	63,00,000	63,00,000	0		0
Deferred income - government grants	(14,00,000)	0	(14,00,000)	excluded	0
Liability for product warranty costs	(5,60,000)	0	(5,60,000)	deductible	1,79,200
Trade payables	(2,67,40,000)	(2,67,40,000)	0		0
Medical benefits for employees	(24,50,000)	0	(24,50,000)	deductible	7,84,000
Deferred tax asset - total					23,07,200
Deferred tax liability - total					(31,58,400)
Deferred tax total					(8,51,200)

Question 1 (MTP - AUG 2018)

QA Ltd. is in the process of computation of the deferred taxes as per applicable Ind AS. QA Ltd. had acquired 40% shares in GK Ltd. for an aggregate amount of Rs. 45 crores. The shareholding gives QA Ltd. significant influence over GK Ltd. but not control and therefore the said interest in GK Ltd. is accounted using the equity method. Under the equity method, the carrying value of investment in GK Ltd. was Rs. 70 crores on 31st March, 2017 and Rs.75 crores as on 31st March, 2018. As per the applicable tax laws, profits recognised under the equity method are taxed if and when they are distributed as dividend or the relevant investment is disposed of.

QA Ltd. wants you to compute the deferred tax liability as on 31st March, 2018 and the charge to the Statement of Profit for the same. Consider the tax rate at 20%.

Solution:**DTL created on accumulation of undistributed profits as on 31.3.2018**

	Carrying value	Value as per tax records	Tax base	Taxable temporary differences	Total Deferred tax liability @ 20%	Charged to P&L during the year
a	b	c	d	E= b-d	F = e x 20%	g
31 st March, 2017	70 crore	45 crore	45 crore	25 crore	5 crore	5 crore
31st March, 2018	75 crore	45 crore	45 crore	30 crore	6 crore	1 crore (6 crore – 5 crore)

Question 2 (MTP - MARCH 2019)

QA Ltd. is in the process of computation of the deferred taxes as per applicable Ind AS and wants guidance on the tax treatment for the following:

(i) QA Ltd. does not have taxable income as per the applicable tax laws, but pays 'Minimum Alternate Tax' (MAT) based on its books profits. The tax paid under MAT can be carried forward for the next 10 years and as per the Company's projections submitted to its bankers, it is in a position to get credit for the same by the end of eighth year. The Company is recognising the MAT credit as a current asset under IGAAP. The amount of MAT credit as on 31st March, 2016 is Rs. 8.5 crores and as on 31st March, 2017 is Rs. 9.75 crores;

(ii) The Company measures its head office property using the revaluation model. The property is revalued every year as on 31st March. On 31st March, 2016, the carrying value of the property (after revaluation) was Rs. 40 crores whereas its tax base was Rs. 22 crores. During the year ended 31st March, 2017, the Company charged depreciation in its Statement of Profit and Loss of Rs. 2 crores and claimed a tax deduction for tax depreciation of Rs. 1.25 crores. On 31st March, 2017, the property was revalued to Rs.45 crores. As per the tax laws, the revaluation of Property, Plant & Equipment does not affect taxable income at the time of revaluation.

The Company has no other temporary differences other than those indicated above. The Company wants you to compute the deferred tax liability as on 31st March, 2017 and the charge/credit to the Statement of Profit and Loss and/or Other Comprehensive Income for the same. Consider the tax rate at 20%.

Solution:**COMPUTATION OF DEFERRED TAX LIABILITY**

(i) MAT credit as on 31st December of Rs.9.75 crore will be presented in the Balance Sheet as Deferred tax asset. DTA in the current year will be Rs.1.25 crore (Rs. 9.75 crore – Rs. 8.50 crore)

(ii) (a) In case defer tax is created only on account of depreciation

	Carrying value without revaluation	Value as per tax records	Tax base	Taxable / (deductible) temporary difference	Total Deferred tax liability/ (asset) @ 20%	Credit to P&L during the year
A	b	c	d	E = b-d	F = e x 20%	g
31st March, 2016	22 crore	22 crore	22 crore	nil	nil	nil
Less: Depreciation for the year 2016- 17	(2 crore)	(1.25 crore)				
Carrying value as on 31st March, 2017	20 crore	20.75 crore	20.75 crore	(0.75 crore)	DTA (0.15 crore)	DTA (0.15 crore)

Computation of tax effect taking into account the revalued figures and adjusting impact of tax effect on account of difference in depreciation

S. No.		Carrying value after revaluation	Value as per tax records	Tax base	Taxable / (deductible) temporary difference	Total Deferred tax liability/ (asset) @ 20%	Credit to P&L during the year	Charged to OCI during the year
	a	b	c	d	E = b-d	F = e x 20%	g	h
I	31st March, 2016	40 crore	22 crore	22 crore	18 crore	DTL 3.6 crore	-	DTL 3.6 crore
IV	Revalued again on 31.3.2017 (It is assumed that revaluation has been done after taking into consideration the impact of depreciation for the current year)	45 crore	20.75 crore (22-1.25)	20.75 crore	24.25 crore	DTL 4.85 crore	DTA (0.15 crore) (Refer table (a) above)	DTL 5 crore (Refer Note below) [5 DTL (B/F) – 0.15 DTA = 4.85 DTL]
V	Additional DTL/DTA required during the year (IV-I)					DTL 1.25 crore	DTA (0.15 crore) (Refer table (a))	DTL (1.40 crore) (Refer Note below)

Note:

As per para 65 of Ind AS 12, 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 on account of revaluation of asset and the adjustment of the tax base are recognised in other comprehensive income in the periods in which they occur.

Here, it is important to understand that only the tax effects on account of revaluation of asset and the adjustment of the tax base are recognised in other comprehensive income. However, tax effects on account of depreciation of asset and the adjustment of the tax base are recognized in profit and loss.

Accordingly, first of all the tax effect has been calculated assuming that there is no revaluation (Refer Table (a) above) [Since the information for the carrying value before revaluation has not been mentioned, it is assumed to be equal to the carrying amount as per the tax records]. Later the DTA arrived due to difference in depreciation is adjusted with the DTL created due to revaluation. DTA of Rs. 0.15 crore on account of depreciation will be charged to Profit and Loss and DTL of Rs. 1.40 crore will be charged to OCI. Net effect in the year 31.3.2017 will be DTL 1.25 crore (DTL 1.4 crore – DTA 0.15 crore) [Refer Table (b) above].

Question 3 (Past Exam – Nov 2020)

Note: This question is already there in module (Illustration 16 of this book) but it has been again given here as in exam one extra working of Effective Interest Rate was asked.

Parent Limited, prepares consolidated financial statements of the group on 31 March every year. During the year ended 31 March 2020, the following events affected the tax position of the group:

- S Limited, a wholly owned subsidiary of Parent Limited, incurred a loss of ₹ 20,00,000 which is adjustable from future taxable profits of the company for tax purposes. S Limited is unable to utilize this loss against previous tax liabilities. Income Tax Act does not allow S Limited to transfer the tax loss to other group companies. However, it allows S Limited to carry forward the loss and utilize it against company's future taxable profits. The directors of Parent Limited estimate that S Limited will not make any taxable profits in the foreseeable future.
- On 1 April 2019, Parent Limited borrowed ₹ 50,00,000. The cost incurred by Parent Limited for arranging the borrowing was ₹ 1,00,000 on the said date and this expenditure is qualified for deduction under the Income Tax Act for the accounting year 2019-2020. The loan was given for a three-year period. As per agreement, no principal or interest was payable on the loan during the tenure of loan but the amount repayable on 31 March 2022 will be by way of a bullet payment of ₹ 65,21,900. As per Parent Limited, this equates to an effective annual interest rate of 10% on loan. As per the Income-tax Act, a further expense of ₹ 15,21,900 will be claimable from taxable income till the loan is repaid on 31 March 2022.

The rate of corporate income tax to be assumed @ 20%.

Explain and show how each of these events would affect the deferred tax assets/liabilities in the consolidated balance sheet of Parent Limited as at 31 March 2020 as per applicable Ind AS.

You are also required to examine whether the effective rate of interest arrived at by Parent Limited for the loan of ₹ 50,00,000 is in accordance with applicable Ind AS or not? (6 Marks)

Solution:

- The tax loss creates a potential deferred tax asset for the group since its carrying value is nil and its tax base is ₹ 20,00,000.

However, no deferred tax asset can be recognised because there is no prospect of being able to reduce tax liabilities in the foreseeable future as no taxable profits are anticipated.

- The carrying value of the loan at 31 March 2020 is ₹ 53,90,000 (₹ 50,00,000 – ₹ 1,00,000 + (₹ 49,00,000 × 10%)).

The tax base of the loan is ₹ 50,00,000.

This creates a deductible temporary difference of ₹ 3,90,000 (₹ 53,90,000 – ₹ 50,00,000) and a potential deferred tax asset of ₹ 78,000 (₹ 3,90,000 × 20%).

If there are prospects of availability of taxable profits in future, deferred tax asset can be recognised.

Amortisation Table for verification of effective rate of interest

Year	Opening balance (₹) (A)	Interest @ 10% (₹) (B)	Closing balance (₹) (A) + (B)
1	(50,00,000 – 1,00,000) 49,00,000	4,90,000	53,90,000
2	53,90,000	5,39,000	59,29,000
3	59,29,000	5,92,900	65,21,900

Since the closing balance calculated as per the above table on the basis of 10% matches with the bullet payment of ₹ 65,21,900, it assures that 10% rate of interest taken as effective rate of interest is correct and is in accordance with Ind AS 109. It considers the impact of cost of borrowing adjusted from the loan amount at initial recognition.

Question 4 (RTP May'21)

The entity has an identifiable asset ASSOTA with a carrying amount of ₹ 10,00,000. Its recoverable amount is ₹ 6,50,000. The tax base of ASSOTA is ₹ 8,00,000 and the tax rate is 30%. Impairment losses are not tax deductible. Entity expects to continue to earn profits in future.

For the identifiable asset ASSOTA, what would be the impact on the deferred tax asset/ liability at the end of the period?

Solution:

As per Ind AS 36, the revised carrying amount of asset ASSOTA would be ₹6,50,000.

The tax base of asset ASSOTA is given as ₹8,00,000.

Carrying base of asset = ₹6,50,000

Tax base of asset = ₹8,00,000

Since tax base is greater than carrying base of asset, so deferred tax asset would be created on the temporary difference of ₹1,50,000 (₹8,00,000 – ₹6,50,000) at the given tax rate of 30%.

Hence, Deferred tax asset for the asset ASSOTA would be ₹1,50,000 x 30% = ₹45,000.

Question 5 (RTP Nov'22) (Past Exam Nov'22)

Following is the summarized statement of profit and loss of EARTH Limited as per Ind AS for the year ended 31st March 20X1:

Particulars	₹ In Crore
Revenue from operations	1,160.00
Other income	56.00
Total Income (A)	1,216.00
Purchase of stock-in-trade	40.00
Changes in inventories of stock-in-trade	6.00
Employee benefits expense	116.00
Finance costs	130.00
Depreciation and amortization expense	30.00
Other expenses	300.00
Total Expenses (B)	622.00
Profit Before Tax (A-B)	594.00
Current tax	165.40
Deferred tax	(1.50)
Tax Expenses	163.90
Profit after Tax	430.10

Additional information:

- Corporate income tax rate applicable to EARTH Limited is 30%.
- Other income includes long-term capital gains of ₹ 10 crore which are taxable at the rate of 10%.
- Other expenses include the following items which are not deductible for income tax purposes:

Item	₹ in Crore
Penalties	1.00

Impairment of goodwill	44.00
Corporate Social Responsibility expense	6.00

- Other expenses include research and development (R & D) expenditure of ₹ 8 crore in respect of which a 200% weighted deduction is available under income tax laws.
- Other income includes dividends of ₹ 4 crore, which is exempt from tax.
- Profit before tax of ₹ 594 crore includes (i) agriculture income of ₹ 55 crore which is exempt from tax; and (ii) profit of ₹ 60 crore earned in the USA on which EARTH Limited is required to pay tax at the rate of 20%.
- Depreciation as per income tax laws is ₹ 25.0 crore.

During review of the financial statements of EARTH Limited, the CFO multiplied profit before tax by the income tax rate and arrived at ₹ 178.2 crore as the tax expense ($₹ 594 \text{ crore} \times 30\% = ₹ 178.2 \text{ crore}$). However, actual income tax expense appearing in the summarized statement of profit and loss is ₹ 166.9 crore.

The CFO has sought your help in reconciling the difference between the two tax expense amounts. Prepare a reconciliation containing the disclosure as required under the relevant Ind AS. (6 Marks)

(Note: Deferred Tax line item & Depreciation adjustment was not there when it was asked in exam)

Solution:

Particulars		₹ in crore
Accounting profit		594.00
Tax at the applicable tax rate of 30%		178.20
Tax effect of expenses that are not deductible in determining taxable profits:		
Penalties (1.00 x 30%)	0.30	
Impairment of goodwill (44.00 x 30%)	13.20	
Corporate social responsibility expense (6.00 x 30%)	1.80	15.30
Tax effect of expenses that are deductible in determining taxable profits:		
Research and development expenses (8.00 x 30%)		(2.40)
Tax effect of income that are exempted in determining taxable profits:		
Dividend income (Exempt) (4.00 x 30%)	1.20	
Agriculture income (Exempt) (55.00 x 30%)	16.50	(17.70)
Tax effect of income on which different tax rates are used for determining taxable profits:		
Differential income tax on long term capital gain [10.00 x (30% - 10%)]	2.00	
Foreign income in USA [60.00 x (30% - 20%)]	6.00	(8.00)
Income tax expense (Current) reported in the Statement of Profit and Loss for the current year		165.40

Reconciliation of deferred tax:

Particulars	₹ in crore
Deferred tax in relation to depreciation and amortization [(30 - 25) x 30%]	1.50
Tax expense (deferred) reported in the Statement of Profit or Loss for the current year	1.50

Question 6 (RTP Nov'23)

On 1st April, 20X1, an entity paying tax at 30% acquired a non-tax-deductible office building for ₹ 1,00,000 in circumstances in which Ind AS 12 prohibits recognition of the deferred tax liability associated with the temporary difference of ₹ 1,00,000. The building is depreciated over 10 years at ₹ 10,000 per year to a residual value of zero. The entity's financial year ends on 31st March.

On 1st April, 20X2, the carrying amount of the building is ₹ 90,000, and it is revalued upwards by ₹ 45,000 to its current market value of ₹ 1,35,000. There is no change to the estimated residual value of zero, or to the useful life of the building after revaluation.

Determine the carrying amount, depreciation for the year ended 31st March, 20X3 and defer tax thereafter till the useful life of the building. Further analyse the treatment and impact of defer tax since 31st March, 20X3 till the useful life of the building.

Solution:

Since there is no change to the estimated residual value of zero, or to the useful life of the building after revaluation, at the end of the 2nd year i.e. 31st March 20X3, the building will be depreciated over the next 9 years at ₹ 15,000 per year.

Following the revaluation, the temporary difference associated with the building is ₹ 1,35,000. Of this amount, only ₹ 90,000 arose on initial recognition, since ₹ 10,000 of the original temporary difference of ₹ 1,00,000 arising on initial recognition of the asset has been eliminated through depreciation of the asset. The carrying amount (which equals the temporary difference, since the tax base is zero) and depreciation during the year ended 31st March, 20X3 and thereafter may then be analysed as follows:

Year	Carrying amount (a)	Tax base (b)	Gross temporary difference (c = a-b)	Unrecognised temporary difference d	Recognised temporary difference (e = c-d)	Deferred tax liability f = e @ 30%
0	1,00,000	-	1,00,000	1,00,000	-	-
1	90,000	-	90,000	90,000	-	-
Reval	1,35,000	-	1,35,000	90,000	45,000	13,500
2	1,20,000	-	1,20,000	80,000	40,000	12,000
3	1,05,000	-	1,05,000	70,000	35,000	10,500
4	90,000	-	90,000	60,000	30,000	9,000
5	75,000	-	75,000	50,000	25,000	7,500
6	60,000	-	60,000	40,000	20,000	6,000
7	45,000	-	45,000	30,000	15,000	4,500
8	30,000	-	30,000	20,000	10,000	3,000
9	15,000	-	15,000	10,000	5,000	1,500
10	-	-	-	-	-	-

Note: The depreciation is allocated pro rata to the cost element and revalued element of the total carrying amount.

On 31st March, 20X3, the entity recognises a deferred tax liability based on the temporary difference of ₹ 45,000 arising on the revaluation (i.e., after initial recognition) giving a deferred tax expense of ₹ 13,500 (₹ 45,000 @ 30%) recognised in Other Comprehensive Income (OCI).

This has the result that the effective tax rate shown in the financial statements for the revaluation is 30% (₹ 45,000 gain with deferred tax expense of ₹ 13,500).

As can be seen from the table above, as at 31st March, 20X4 (year 3), ₹ 40,000 of the total temporary difference arose after initial recognition. The entity, therefore, provides for deferred tax of ₹ 12,000 (₹ 40,000 @ 30%), and a deferred tax credit of ₹ 1,500 (the reduction in the liability from ₹ 13,500 to ₹ 12,000) is recognised in profit or loss.

The deferred tax credit can be explained as the tax effect at 30% of the additional ₹ 5,000 depreciation relating to the revalued element of the building.

EXAMPLE 1

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).

Case A: 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%).

Case B: 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:

Sale proceeds = ₹ 150

Sale proceeds in excess of cost (₹ 100) = ₹ 50

Taxable proceeds = ₹ 100

Tax base = ₹ 70

Taxable temporary difference = ₹ 30

Tax rate = 30%

Deferred tax liability = ₹ 9

EXAMPLE 2

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, December 31, 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 March 15, 20X2 the entity recognises dividends of ₹ 10,000 from previous operating profits as a liability.

On March 15, 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.

IND AS 16 – PROPERTY, PLANT AND EQUIPMENT

Illustration 1

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 years 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. Also pass necessary journal entry

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	Dr.	95,00,000	
To Cash			33,33,333
To Accounts Payable			61,66,667
(Initial recognition of property)			
On 31st March 20X2			
Interest Expense	Dr.	3,30,533	
Accounts Payable	Dr.	30,02,800	
To Cash			33,33,333
(Recognition of interest expense and payment of second installment)			
On 31st March 20X3			
Interest Expense	Dr.	1,69,467	
Accounts Payable	Dr.	31,63,867	
To Cash			33,33,334
(Recognition of interest expense and payment of final installment)			

Working Note

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	<u>1,00,00,000</u>		<u>95,00,000</u>

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 $[(31,63,867 \times 5.36\%) - (33,33,334 - 31,63,867)]$ is due to approximation.

Illustration 2

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 ₹18 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 recognise the private jet at a cost of ₹18 million (being ₹15 million plus 3 million cash) and should recognise a profit on disposal of the land and building of ₹5 million, calculated as follow:

Particulars	(₹ 000)
Recognition of Fair value of Asset acquired (15000 + 3000)	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

Illustration 3

Jupiter Ltd. has an item of plant 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 relating to treatment of accumulated depreciation?

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

(Being the entry to increase both the original cost and the accumulated depreciation by 44.44%)

Illustration 4

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. Analyse the accounting treatment to be applied by the management in the light of Ind AS 16?

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 IND AS 16.

Illustration 5

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.

Calculate depreciation and revaluation surplus for 20X3-20X4 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

Illustration 6

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 for the years 1,2,3.

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	$\frac{10,000 - 2,000}{10} = 800$	$\frac{10,000 - 2,000}{10} = 800$	$\frac{8,400 - 2,000}{4} = 1,600$

Illustration 7

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.

Calculate the depreciation charge for respective years in accordance with 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	₹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).

Illustration 8 (MTP Nov'23)

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%.

Analyse whether the cost of the new turbine can be recognized as an asset, and, if yes, then apply the accounting treatment relevant to it? **(7 Marks)**

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.

Illustration 9

On April 1, 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 April 20, 20X1. Compute the cost of the asset to be recognized?

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:

Particulars	₹
List price	80,00,000
Less: Trade discount (10%)	<u>(8,00,000)</u>
	72,00,000
Import duty	5,00,000
Delivery fees	1,00,000
Electrical installation costs	10,00,000
Pre-production testing	<u>4,00,000</u>
Total amount to be capitalised at April 1, 20X1	<u>92,00,000</u>

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.

Illustration 10

X Limited started construction on a building for its own use on April 1, 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 January 1, 20X1 and brought in use April 1, 20X1. X Limited had taken a loan of ₹40,00,000 on April 1, 20X0 for construction of the building. The loan carried an interest rate of 8% per annum and is repayable on April 1, 20X2. Assume that the entity did not consider the construction period as substantial period of time as per Ind AS 23.

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) :

Particulars	₹
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 (Refer Note 1)	NIL
Total to be capitalized	45,78,000

*Assuming that period for Construction of building is not a substantial period (i.e. 9 months) here, borrowing cost are not eligible for capitalisation.

Illustration 11

XYZ Ltd. purchased an asset on January 1, 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 January 1, 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 January 1, 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.

Illustration 12 – (MTP Nov'21)

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 (which is considered as substantial period of time as per Ind AS 23) 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%. During the period 1st April, 20X1 to 31st August, 20X1 (when the loan proceeds had been fully utilised to finance the construction), Sun Ltd received investment income of ₹100,000 on the temporary investment of the proceeds. (10 Marks)

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 an 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	$9,912.50 \times 30\% \times 1/20 \times 4/12$
Depreciation of remainder	57.82	$9,912.50 \times 70\% \times 1/40 \times 4/12$
Total depreciation	107.38	
Computation of carrying amount	19,805.12	$19,912.50 - 107.38$

Illustration 13

H Limited purchased an item of PPE costing ₹ 100 million which has useful life of 10 years. The entity has a contractual decommissioning and site restoration obligation, estimated at ₹ 5 million to be incurred at the end of 10th year. The current market based discount rate is 8%.

The company follows SLM method of depreciation. H Limited follows the Cost Model for accounting of PPE.

Determine the carrying value of an item of PPE and decommissioning liability at each year end when:

- a) There is no change in the expected decommissioning expenses, expected timing of incurring the decommissioning expense and / or the discount rate
- b) At the end of Year 4, the entity expects that the estimated cash outflow on account of decommissioning and site restoration to be incurred at the end of the useful life of the asset will be ₹ 8 million (in place of ₹ 5 million, estimated in the past).

Determine in case (b), how H Limited need to account for the changes in the decommissioning liability?

Solution:

The present value of such decommissioning and site restoration obligation at the end of 10th year is ₹ 2.32 million [being $5 / (1.08)^{10}$]. H Limited will recognise the present value of decommissioning liability of ₹ 2.32 million as an addition to cost of PPE and will also recognize a corresponding decommissioning liability. Further, the entity will recognise the unwinding of discount as finance charge.

- a) The following table shows the relevant computations, if there is no change in the expected decommissioning expenses, expected timing of incurring the decommissioning expense and / or the discount rate:

(₹ in million)

Year	Opening Amount of PPE	Depreciation Charge (on SLM) for 10 Years	Carrying Amount of PPE at the end of the year	Opening Decommissioning Liability	Unwinding of Interest @ 8%	Closing Decommissioning Liability
1	102.32	10.23	92.08	2.32	0.19	2.50
2	92.08	10.23	81.85	2.50	0.20	2.70
3	81.85	10.23	71.62	2.70	0.22	2.92
4	71.62	10.23	61.39	2.92	0.23	3.15
5	61.39	10.23	51.16	3.15	0.25	3.40
6	51.16	10.23	40.93	3.40	0.27	3.68
7	40.93	10.23	30.69	3.68	0.29	3.97
8	30.69	10.23	20.46	3.97	0.32	4.29
9	20.46	10.23	10.23	4.29	0.34	4.63
10	10.23	10.23	-	4.63	0.37	5.00
Total		102.32			2.68	

b) The changes to the estimate of expected decommissioning obligation:

- The present value of the decommissioning liability at the end of Year 4 works out to be ₹ 5.04 million [being $8 / (1.08)^6$].
- As against this, the carrying amount of decommissioning liability at the end of Year 4 is ₹ 3.15 million (as computed above).
- The changes in the decommissioning liability of ₹ 1.89 million (being ₹ 5.04 million less ₹ 3.15 million) shall be added to the cost of the asset in the current period and the related provision for decommissioning liability is also adjusted.

The journal entry will be:

PPE Dr. ₹ 1.89 million
To Provision for decommissioning liability ₹ 1.89 million

- The following table shows the calculations for years 5 - 10:

Year	Opening Amount of PPE	Depreciation Charge SLM – 10 Years	Carrying Amount of PPE at end of the year	Opening Decommissioning Liability	Unwinding of Interest @8%	Closing Decommissioning Liability
5	63.28	10.55	52.73	5.04	0.40	5.44
6	52.73	10.55	42.19	5.44	0.44	5.88
7	42.19	10.55	31.64	5.88	0.47	6.35
8	31.64	10.55	21.09	6.35	0.51	6.86

9	21.09	10.55	10.55	6.86	0.55	7.41
10	10.55	10.55	-	7.41	0.59	8.00
Total		63.28			2.96	

Note that in the above table:

- Opening amount of PPE at the beginning of Year 5 is computed as ₹ 63.28 million (being carrying amount of ₹ 61.39 million at the end of Year 4 plus increase of ₹ 1.89 million arising due to increase in the present value of the decommissioning liability at the end of Year 4).
- The revised carrying amount of PPE (at ₹ 63.28 million) at the beginning of Year 5 will be depreciated over the balance 6 years of the useful life).
- Opening decommissioning liability at the beginning of Year 5 is computed as ₹ 5.04 million (being carrying amount of ₹ 3.15 million at the end of Year 4 plus increase of ₹ 1.89 million).

Since the entity has adjusted the increase in the decommissioning liability against the carrying amount of PPE, it needs to evaluate whether the new carrying amount (in this case, ₹ 63.28 million) is recoverable. If not, it will give rise to impairment loss, to be accounted for under Ind AS 36.

Illustration 14

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

Advise ABC Ltd. on the costs that can be capitalized in accordance with IND AS 16.

Solution

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.

Illustration 15

A Ltd. has an item of plant 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?

Solution

The entries to be passed would be:

		₹	₹
Accumulated depreciation To Asset A/c (Being elimination of accumulated depreciation against the cost of the asset)	Dr.	55,000	55,000
Asset A/c To Revaluation Surplus (Being increase of net asset value to Fair value)	Dr	20,000	20,000

Note: The net result is that the asset has a carrying amount of ₹ 65,000 [1,00,000 – 55,000 + 20,000.]

Illustration 16

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.

Analyse how would the above changes in estimates be made by B Ltd.?

Solution

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).

Illustration 17

X Ltd. has a machine which got damaged due to fire as on January 31, 20 X1. 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 March 31, 20 X1, 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. Determine the accounting for the above transaction for X Ltd

Solution

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 March 31, 20X1, X Ltd. should recognise income of ₹50,000 against the compensation receivable in its profit or loss.

Illustration 18

An entity has a nuclear power plant and a related decommissioning liability. The nuclear power plant started operating on April 1, 2X01. 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 March 31. On March, 2X11, value of the decommissioning liability has decreased by ₹8,000. The discount rate has not yet changed.

Examine how the entity will account for the above changes in decommissioning liability in the 11th year if it adopts cost model?

Solution

On March 31, 2X11, the plant is 10 years old. Accumulated depreciation is ₹30,000 ($₹1,20,000 \times 10 / 40$ years). Because of the unwinding of discount (5 per cent) over the 10 years, the decommissioning liability has increased from ₹10,000 to ₹16,300.

On March 31, 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 makes the following journal entry to reflect the change:

Decommissioning liability	Dr.	8,000	
To Cost of 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 ($₹82,000 \div 30$). The next year's finance cost for the unwinding of the discount will be ₹415 ($₹8,300 \times 5$ per cent).

Illustration 19

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?

Solution

At March 31, 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)	15,600

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:

- 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.
- 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.

- Three years' depreciation on original cost ₹ 1,20,000 $\times$ $\frac{3}{40}$ = ₹ 9,000 plus cumulative discount on ₹ 10,000 at 5 per cent compound = ₹ 1,600; total ₹ 10,600.
- 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 ($\frac{1,26,600}{1} \times \frac{1}{37}$) 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:

Prov for Decommissioning liability	Dr.	5,000	
To Revaluation Surplus			5,000

As at March 31, 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:

- Eliminating accumulated depreciation of ₹3,420 in accordance with the entity's accounting policy.
- 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.
- 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 March 31, 20X4, plus depreciation expense of ₹3,420 and discount expense of ₹600 = ₹14,620.

(2) ₹15,600 at March 31, 20X4, plus ₹5,000 arising on the decrease in the liability, less ₹8,980 deficit on revaluation = ₹11,620.

Illustration 20 - (RTP May'18, MTP Oct'21)

A Ltd. purchased some Property, Plant and Equipment on 1st April, 20X1, and estimated their useful lives for the purpose of financial statements prepared on the basis of Ind AS: Following were the original cost, and useful life of the various components of property, plant, and equipment assessed on 1st April, 20X1:

Property, Plant and Equipment	Original Cost	Estimated useful life
Buildings	₹ 15,000,000	15 years
Plant and machinery	₹ 10,000,000	10 years
Furniture and fixtures	₹ 3,500,000	7 years

A Ltd. uses the straight-line method of depreciation. On 1st April, 20X4, the entity reviewed the following useful lives of the property, plant, and equipment through an external valuation expert:

Buildings	10 years
Plant and machinery	7 years
Furniture and fixtures	5 years

There were no salvage values for the three components of the property, plant, and equipment either initially or at the time the useful lives were revised.

Compute the impact of revaluation of useful life on the Statement of Profit and Loss for the year ending 31st March, 20X5. **(7 Marks)**

Solution

The annual depreciation charges prior to the change in useful life were

Buildings	= ₹1,50,00,000/15	₹ 10,00,000
Plant and machinery	= ₹1,00,00,000/10	₹ 10,00,000
Furniture and fixtures	= ₹35,00,000/7	₹ 5,00,000
Total		₹ 25,00,000 (A)

The revised annual depreciation for the year ending 31st March, 20X4, would be

Buildings	[₹1,50,00,000 – (₹ 10,00,000 × 3)] / 10	₹ 12,00,000
Plant and machinery	[₹ 1,00,00,000 – (₹ 10,00,000 × 3)] / 7	₹ 10,00,000
Furniture and fixtures	[₹ 35,00,000 – (₹ 5,00,000 × 3)] / 5	₹ 4,00,000
Total		₹ 26,00,000 (B)

The impact on Statement of Profit and Loss for the year ending 31st March, 20X4

$$= ₹ 26,00,000 - ₹ 25,00,000 = ₹ 1,00,000$$

This is a change in accounting estimate which is adjusted prospectively in the period in which the estimate is amended and, if relevant, to future periods if they are also affected. Accordingly, from 20X4-20X5 onward, excess of ₹ 1,00,000 will be charged in the Statement of Profit and Loss every year till the time there is any further revision.

Illustration 21

Mr. X, is the financial controller of ABC Ltd., a listed entity which prepares consolidated financial statements in accordance with Ind AS. Mr. X has recently produced the final draft of the financial statements of ABC Ltd. for the year ended 31st March, 2018 to the managing director Mr. Y for approval. Mr. Y, who is not an accountant, had raised following query from Mr. X after going through the draft financial statements:-

The notes to the financial statements state that plant and equipment is held under the 'cost model'. However, property which is owner occupied is revalued annually to fair value. Changes in fair value are sometimes reported in profit or loss but usually in 'other comprehensive income'. Also, the amount of depreciation charged on plant and equipment as a percentage of its carrying amount is much higher than for owner occupied property. Another note states that property owned by ABC Ltd. but rent out to others is depreciated annually and not fair valued. Mr. Y is of the opinion that there is no consistent treatment of PPE items in the accounts. Advise the finance controller for resolving the query of the managing director?

Solution:

Ongoing through the query raised by the Managing Director Mr. Y, the financial controller Mr. X explained the notes and reasons for their disclosures as follows:

The accounting treatment of the majority of tangible non-current assets is governed by Ind AS 16 'Property, Plant and Equipment'. Ind AS 16 states that the accounting treatment of PPE is determined on a class by class basis. For this purpose, property and plant would be regarded as separate classes. Ind AS 16 requires that PPE is measured using either the cost model or the revaluation model. This model is applied on a class by class basis and must be applied consistently within a class. Ind AS 16 states that when the revaluation model applies, surpluses are recorded in other comprehensive income, unless they are cancelling out a deficit which has previously been reported in profit or loss, in which case it is reported in profit or loss. Where the revaluation results in a deficit, then such deficits are reported in profit or loss, unless they are cancelling out a surplus which has previously been reported in other comprehensive income, in which case they are reported in other comprehensive income.

According to Ind AS 16, all assets having a finite useful life should be depreciated over that life. Where property is concerned, the only depreciable element of the property is the buildings element, since land normally has an indefinite life. The estimated useful life of a building tends to be much longer than for plant. These two reasons together explain why the depreciation charge of a property as a percentage of its carrying amount tends to be much lower than for plant.

Properties which are held for investment purposes are not accounted for under Ind AS 16, but under Ind AS 40 'Investment Property'. As per Ind AS 40, investment properties should be accounted for under a cost model. ABC Ltd. had applied the cost model and thus our investment properties are treated differently from the owner occupied property.

Illustration 23 – (RTP - May 2020) + (MTP – March 2021)

Company X performed a revaluation of all of its plant and machinery at the beginning of 20X1. The following information relates to one of the machinery:

	Amount ('000)
Gross carrying amount	₹ 200
Accumulated depreciation (straight-line method)	(₹ 80)
Net carrying amount	₹ 120
Fair value	₹ 150

The useful life of the machinery is 10 years and the company uses Straight line method of depreciation. The revaluation was performed at the end of 4 years.

How should the Company account for revaluation of plant and machinery and depreciation subsequent to revaluation? Support your answer with journal entries.

Solution:

According to paragraph 35 of Ind AS 16, 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.

In such a situation, the revised carrying amount of the machinery will be as follows:

Gross carrying amount	₹ 250	$[(200/120) \times 150]$
Net carrying amount	₹ 150	
Accumulated depreciation	₹ 100	(₹ 250 – ₹ 150)

Journal entry

Plant and Machinery (Gross Block)	Dr. ₹ 50	
	To Accumulated Depreciation	₹ 20
	To Revaluation Reserve	₹ 30

Depreciation subsequent to revaluation

Since the Gross Block has been restated, the depreciation charge will be ₹ 25 per annum (₹ 250/10 years).

Journal entry

Accumulated Depreciation	Dr. ₹ 25 p.a.	
	To Plant and Machinery (Gross Block)	₹ 25 p.a.

- (b) The accumulated depreciation is eliminated against the gross carrying amount of the asset.

The amount of the adjustment of accumulated depreciation forms part of the increase or decrease in carrying amount that is accounted for in accordance with the paragraphs 39 and 40 of Ind AS 16.

In this case, the gross carrying amount is restated to ₹ 150 to reflect the fair value and accumulated depreciation is set at zero.

Journal entry

Accumulated Depreciation	Dr. ₹ 80	
	To Plant and Machinery (Gross Block)	₹ 80
Plant and Machinery (Gross Block)	Dr. ₹ 30	
	To Revaluation Reserve	₹ 30

Depreciation subsequent to revaluation

Since the revalued amount is the revised gross block, the useful life to be considered is the remaining useful life of the asset which results in the same depreciation charge of ₹ 25 per annum as per Option A (₹ 150 / 6 years).

Journal entry

Accumulated Depreciation	Dr. ₹ 25 p.a.	
	To Plant and Machinery (Gross Block)	₹ 25 p.a.

Illustration 24 (RTP – May 2021)

An entity has the following items of property, plant and equipment:

- Property A — a vacant plot of land on which it intends to construct its new administration headquarters;
- Property B — a plot of land that it operates as a landfill site;

- Property C — a plot of land on which its existing administration headquarters are built;
- Property D — a plot of land on which its direct sales office is built;
- Properties E1–E10 — ten separate retail outlets and the land on which they are built;
- Equipment A — computer systems at its headquarters and direct sales office that are integrated with the point of sale computer systems in the retail outlets;
- Equipment B — point of sale computer systems in each of its retail outlets;
- Furniture and fittings in its administrative headquarters and its sales office;
- Shop fixtures and fittings in its retail outlets.

Determine the classes of property, plant and equipment for disclosure by the entity?

SOLUTION

To answer this question one must make a materiality judgement.

A class of assets is defined as a grouping of assets of a similar nature and use in an entity's operations.

The nature of land without a building is different to the nature of land with a building.

Consequently, land without a building is a separate class of asset from land and buildings. Furthermore, the nature and use of land operated as a landfill site is different from vacant land. Hence, the entity should disclose Property A separately. The entity must apply judgement to determine whether the entity's retail outlets are sufficiently different in nature and use from its office buildings, and thus constitute a separate class of land and buildings.

The computer equipment is integrated across the organisation and would probably be classified as a single separate class of asset.

Furniture and fittings used for administrative purposes could be sufficiently different to shop fixtures and fittings in retail outlets to be classified in two separate classes of assets.

Illustration 25 - (RTP Dec 2021)

Heaven Ltd. had purchased a machinery on 1.4.2X01 for ₹ 30,00,000, which is reflected in its books at written down value of ₹ 17,50,000 on 1.4.2X06. The company has estimated an upward revaluation of 10% on 1.4.2X06 to arrive at the fair value of the asset. Heaven Ltd. availed the option given by Ind AS of transferring some of the surplus as the asset is used by an enterprise.

On 1.4.2X08, the machinery was revalued downward by 15% and the company also re-estimated the machinery's remaining life to be 8 years. On 31.3.2X10 the machinery was sold for ₹ 9,35,000. The company charges depreciation on straight line method.

Prepare machinery account in the books of Heaven Ltd. over its useful life to record the above transactions.

Solution:

In the books of Heaven Ltd. Machinery A/c

Date	Particulars	Amount	Date	Particulars	Amount
1.4.2X01	To Bank/ Vendor	30,00,000	31.3.2X02	By Depreciation (W.N.1)	2,50,000
			31.3.2X02	By Balance c/d	<u>27,50,000</u>
		<u>30,00,000</u>			<u>30,00,000</u>
1.4.2X02	To Balance b/d	27,50,000	31.3.2X03	By Depreciation	2,50,000
			31.3.2X03	By Balance c/d	<u>25,00,000</u>
		<u>27,50,000</u>			<u>27,50,000</u>
1.4.2X03	To Balance b/d	25,00,000	31.3. 2X04	By Depreciation	2,50,000

			31.3.2X04	By Balance c/d	22,50,000
		25,00,000			25,00,000
1.4.2X04	To Balance b/d	22,50,000	31.3.2X05	By Depreciation	2,50,000
			31.3.2X05	By Balance c/d	20,00,000
		22,50,000			22,50,000
1.4.2X05	To Balance b/d	20,00,000	31.3.2X06	By Depreciation	2,50,000
			31.3.2X06	By Balance c/d	17,50,000
		20,00,000			20,00,000
1.4.2X06	To Balance b/d	17,50,000	31.3.2X07	By Depreciation (W.N.2)	2,75,000
1.4.2X06	To Revaluation Reserve @ 10%	1,75,000	31.3.2X07	By Balance c/d	16,50,000
		19,25,000			19,25,000
1.4.2X07	To Balance b/d	16,50,000	31.3.2X08	By Depreciation	2,75,000
			31.3.2X08	By Balance c/d	13,75,000
		16,50,000			16,50,000
1.4.2X08	To Balance b/d	13,75,000	1.4.2X08	By Revaluation Reserve (W.N.4)	1,25,000
			31.3.2X09	By Profit and Loss	81,250
				A/c (W.N.5)	
			31.3.2X09	By Depreciation (W.N.3)	1,46,094
		13,75,000			
			31.3.2X09	By Balance c/d	10,22,656
					13,75,000
1.4.2X09	To Balance b/d	10,22,656	31.3.2X10	By Depreciation	1,46,094
31.3.2X10	To Profit and Loss A/c (balancing figure)	58,438*	31.3.2X10	By Bank A/c	9,35,000
		10,81,094			10,81,094

Working Notes:**1) Calculation of useful life of machinery on 1.4.2X01**

Depreciation charge in 5 years = $(30,00,000 - 17,50,000) = ₹ 12,50,000$ Depreciation per year as per Straight Line method = $12,50,000 / 5 \text{ years} = ₹ 2,50,000$

Remaining useful life = $₹ 17,50,000 / ₹ 2,50,000 = 7 \text{ years}$ Total useful life = 5 years + 7 years = 12 years

2) Depreciation after upward revaluation as on 31.3.2X06

Book value as on 1.4.2X06 17,50,000

Add: 10% upward revaluation 1,75,000

Revalued amount 19,25,000

Remaining useful life 7 years (Refer W.N.1)

Depreciation on revalued amount = $19,25,000 / 7 \text{ years} = ₹ 2,75,000 \text{ lakh}$

3) Depreciation after downward revaluation as on 31.3.2X08 ₹

Book value as on 1.4.2X08 13,75,000

Less: 15% Downward revaluation (2,06,250)

Revalued amount = 11,68,750

Revised useful life 8 years

Depreciation on revalued amount = $11,68,750 / 8 \text{ years} = ₹ 1,46,094$

4) Amount transferred from revaluation reserve

Revaluation reserve on 1.4.2X06 (A) ₹ 1,75,000

Remaining useful life 7 years

Amount transferred every year ($1,75,000 / 7$) ₹ 25,000

Amount transferred in 2 years ($25,000 \times 2$) (B) ₹ 50,000

Balance of revaluation reserve on 1.4.2X08 (A-B) ₹ 1,25,000

5) Amount of downward revaluation to be charged to Profit and Loss Account

Downward revaluation as on 1.4.2X08 (W.N.3) ₹ 2,06,250

Less: Adjusted from Revaluation reserve (W.N.4) (₹ 1,25,000)

Amount transferred to Profit and Loss Account ₹ 81,250

Question 1 - (MTP - AUG 2018)

Great Ltd., acquired a machine on 1st April, 2012 for Rs. 7 crore that had an estimated useful life of 7 years. The machine is depreciated on straight line basis and does not carry any residual value. On 1st April, 2016, the carrying value of the machine was reassessed at Rs. 5.10 crore and the surplus arising out of the revaluation being credited to revaluation reserve. For the year ended March 2018, conditions indicating an impairment of the machine existed and the amount recoverable ascertained to be only Rs. 79 lakhs.

Calculate the loss on impairment of the machine and show how this loss is to be treated in the books of Great Ltd. Great Ltd., had followed the policy of writing down the revaluation surplus by the increased charge of depreciation resulting from the revaluation.

SOLUTION:**Statement Showing Impairment Loss**

	(Rs. in crores)
Carrying amount of the machine as on 1 st April, 2012	7.00
Depreciation for 4 years i.e. 2012-13 to 2015-16 (7 crores x 4yrs / 7yrs)	(4.00)
Carrying amount as on 31.03.2016	3.00
Add: Upward Revaluation (credited to Revaluation Reserve account)	2.10
Carrying amount of the machine as on 1 st April 2016 (revalued)	5.10
Less: Depreciation for 2 years i.e. 2016-17 to 2017-18 (5.10 crores x 2yrs / 3yrs)	(3.40)
Carrying amount as on 31.03.2018	1.70
Less: Recoverable amount	(0.79)
Impairment loss	0.91
Less: Balance in revaluation reserve as on 31.03.2018:	
Balance in revaluation reserve as on 31.03.2016	2.10
Less: Enhanced depreciation met from revaluation reserve	
2016-2017 & 2017-2018 = [(1.70 – 1.00) x 2 years]	(1.40)
Impairment loss set off against revaluation reserve balance as per IND AS 36 "Impairment of Assets"	(0.70)
Impairment Loss to be debited to profit and loss account	0.21

Question 2 (MTP - May 2020)

Flying Airways Ltd is a company which manufactures aircraft parts and engines and sells them to large multinational companies like Boeing and Airbus Industries.

On 1 April 20X1, the company began the construction of a new production line in its aircraft parts manufacturing shed.

Costs relating to the production line are as follows:

Details	Amount Rs.'000
Costs of the basic materials (list price Rs.12.5 million less a 20% trade discount)	10,000
Recoverable goods and services taxes incurred not included in the purchase cost	1,000
Employment costs of the construction staff for the three months to 30 June 20X1	1,200

Other overheads directly related to the construction	900
Payments to external advisors relating to the construction	500
Expected dismantling and restoration costs	2,000

Additional Information

The construction staff was engaged in the production line, which took two months to make ready for use and was brought into use on 31 May 20X1.

The other overheads were incurred in the two months period ended on 31 May 20X1. They included an abnormal cost of Rs.3,00,000 caused by a major electrical fault.

The production line is expected to have a useful economic life of eight years. At the end of that time Flywing Airways Ltd is legally required to dismantle the plant in a specified manner and restore its location to an acceptable standard. The amount of Rs.2 million mentioned above is the amount that is expected to be incurred at the end of the useful life of the production line. The appropriate rate to use in any discounting calculations is 5%. The present value of Re.1 payable in eight years at a discount rate of 5% is approximately Re.0.68.

Four years after being brought into use, the production line will require a major overhaul to ensure that it generates economic benefits for the second half of its useful life. The estimated cost of the overhaul, at current prices, is Rs.3 million.

The Company computes its depreciation charge on a monthly basis. No impairment of the plant had occurred by 31 March 20X2

Analyze the accounting implications of costs related to production line to be recognized in the balance sheet and profit and loss for the year ended 31 March, 20X2.

(12 Marks)

Solution:**1. Statement showing Cost of production line:**

Particulars	Amount Rs.'000
Purchase cost	10,000
Goods and services tax – recoverable goods and services tax not included	-
Employment costs during the period of getting the production line ready for use (1,200 x 2800 months / 3 months)	800
Other overheads – abnormal costs	600
Payment to external advisors – directly attributable cost	500
Dismantling costs – recognized at present value where an obligation exists (2,000 x 0.68)	1,360
Total	13,260

Carrying value of production line as on 31st March, 20X2:

Particulars	Amount Rs. '000
Cost of Production line	13,260
Less: Depreciation (W.N.1)	(1,694)
Net carrying value carried to Balance Sheet	11,566

Provision for dismantling cost:

Particulars	Amount Rs. '000
Non-current liabilities	1,360
Add: Finance cost (WN3)	57
Net book value carried to Balance Sheet	1,417

Extract of Statement of Profit & Loss

Particulars	Amount Rs. '000
Depreciation (W.N.1)	1,694
Finance cost (W.N.2)	57
Amounts carried to Statement of Profit & Loss	1,751

Extract of Balance Sheet

Particulars	Amount Rs. '000
Assets	
Non-current assets	
Property, plant and equipment	11,566
Equity and liabilities	
Non-current liabilities	
Other liabilities	
Provision for dismantling cost	1417

Working Notes:**1. Calculation of depreciation charge**

Particulars	Amount Rs. '000
In accordance with Ind AS 16 the asset is split into two depreciable components: Out of the total capitalization amount of 13,260, Depreciation for 3,000 with a useful economic life (UEL) of four years ($3,000 \times \frac{1}{4} \times 10/12$).	
This is related to a major overhaul to ensure that it generates economic benefits for the second half of its useful life	625
For balance amount, depreciation for 10,260 with an useful economic life (UEL) of eight years will be : $10,260 \times \frac{1}{8} \times 10/12$	1,069
Total (To Statement of Profit & Loss for the year ended 31st March 20X2)	1,694

2. Finance costs

Particulars	Amount Rs. '000
Unwinding of discount (Statement of Profit and Loss – finance cost) $1,360 \times 5\% \times 10/12$	57
To Statement of Profit & Loss for the year ended 31st March 20X2	57

Question 3 (RTP - Nov 2018)

On 1st October, 2017, A Ltd. completed the construction of a power generating facility. The total construction cost was ₹ 2,00,00,000. The facility was capable of being used from 1st October, 2017 but A Ltd. did not bring the facility into use until 1st January, 2018. The estimated useful life of the facility at 1st October, 2017 was 40 years. Under legal regulations in the jurisdiction in which A Ltd. operates, there are no requirements to restore the land on which power generating facilities stand to its original state at the end of the useful life of the facility. However, A Ltd. has a reputation for conducting its business in an environmentally friendly way and has previously chosen to restore similar land even in the absence of such legal requirements. The directors of A Ltd. estimated that the cost of restoring the land in 40 years' time (based on prices prevailing at that time) would be ₹ 1,00,00,000. A relevant annual discount rate to use in any discounting calculations is 5%. When the annual discount rate is 5%, the present value of ₹ 1 receivable in 40 years' time is approximately 0.142.

Analyse and present how the above events would be reported in the financial statements of A Ltd. for the year ended 31st March, 2018 as per Ind AS.

Solution

All figures are ₹ in '000.

The power generating facility should be depreciated from the date it is ready for use, rather than when it would actually start being used. In this case, then, the facility should be depreciated from 1st October, 2017.

Although A Ltd. has no legal obligation to restore the piece of land, it does have a constructive obligation, based on its past practice and policies.

The amount of the obligation will be 1,420, being the present value of the anticipated future restoration expenditure ($10,000 \times 0.142$).

This will be recognised as a provision under non-current liabilities in the Balance Sheet of A Ltd. at 31st March, 2018.

As time passes the discounted amount unwinds. The unwinding of the discount for the year ended 31st March, 2018 will be 35.5 ($1,420 \times 5\% \times 6/12$).

The unwinding of the discount will be shown as a finance cost in the statement of profit or loss and the closing provision will be 1,455.50 ($1,420 + 35.5$).

The initial amount of the provision is included in the carrying amount of the non-current asset, which becomes 21,420 ($20,000 + 1,420$).

The depreciation charge in profit or loss for the year ended 31st March, 2018 is 267.75 ($21,420 \times 1/40 \times 6/12$).

The closing balance included in non-current assets will be 21,152.25 ($21,420 - 267.75$).

Question 4 (RTP - Nov 2020)

Entity X has a warehouse which is closer to factory of Entity Y and vice versa. The factories are located in the same vicinity. Entity X and Entity Y agree to exchange their warehouses. The carrying value of warehouse of Entity X is ₹ 1,00,000 and its fair value is ₹ 1,25,000. It exchanges its warehouse with that of Entity Y, the fair value of which is ₹ 1,20,000. It also receives cash amounting to ₹ 5,000. How should Entity X account for the exchange of warehouses?

Solution:

Paragraph 24 of Ind AS 16, inter alia, provides that when an item of property, plant and equipment is acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets, the cost of such an item of property, plant and equipment is measured at fair value unless

- the exchange transaction lacks commercial substance or
- 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.

Further as per paragraph 25 of Ind AS 16, 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.

In the given case, the transaction lacks commercial substance as the company's cash flows are not expected to significantly change as a result of the exchange because the factories are located in the same vicinity i.e. it is in the same position as it was before the transaction.

Hence, Entity X will have to recognise the assets received at the carrying amount of asset given up, i.e., ₹ 1,00,000 being carrying amount of existing warehouse of Entity X and ₹ 5,000 received will be deducted from the cost of property, plant and equipment. Therefore, the warehouse of Entity Y is recognised as property, plant and equipment with a carrying value of ₹ 95,000 in the books of Entity X.

Question 5 (PAST EXAM - Nov 2019)

M Ltd. is setting up a new factory outside the Delhi city limits. In order to facilitate the construction of the factory and its operations, M Ltd. is required to incur expenditure on the construction/ development of electric-substation. Though M Ltd. incurs (or contributes to) the expenditure on the construction/development, it will not have ownership rights on these items and they are also available for use to other entities and public at large. Whether M Ltd. can capitalise expenditure incurred on these items as property, plant and equipment (PPE)? If yes, then how should these items be depreciated and presented in the financial statements of M Ltd. as per Ind AS? (8 Marks)

Solution:

As per Ind AS 16, 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.

Further, Ind AS 16 does not prescribe the unit of measure for recognition, i.e., what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances.

Ind AS 16, further, states that the cost of an item of property, plant and equipment comprise 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.

In the given case, electric-substation is required to facilitate the construction of the refinery and for its operations. Expenditure on these items is required to be incurred in order to get future economic benefits from the project as a whole which can be considered as the unit of measure for the purpose of capitalisation of the said expenditure even though the company cannot restrict the access of others for using the assets individually. It is apparent that the aforesaid expenditure is 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.

In view of this, even though M Ltd. may not be able to recognise expenditure incurred on electric-substation as an individual item of property, plant and equipment in many cases (where it cannot restrict others from using the asset), expenditure incurred may be capitalised as a part of overall cost of the project.

From this, it can be concluded that, in the extant case the expenditure incurred on electric-substation should be considered as the cost of constructing the factory and accordingly, expenditure incurred on electric-substation should be allocated and capitalised as part of the items of property, plant and equipment of the factory.

Depreciation

As per Ind AS 16, 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 shall be depreciated separately.

Further, Ind AS 16 provides that, if these assets have a useful life which is different from the useful life of the item of property, plant and equipment to which they relate, it should be depreciated separately. However, if these assets have a useful life and the depreciation method that are the same as the useful life and the depreciation method of the item of property, plant and equipment to which they relate, these assets may be grouped in determining the depreciation charge. Nevertheless, if it has been included in the cost of property, plant and equipment as a directly attributable cost, it will be depreciated over the useful lives of the said property, plant and equipment.

The useful lives of electric-substation should not exceed that of the asset to which it relates.

Presentation

Electric-substation should be presented within the class of asset to which they relate i.e. factory.

Question 6 (RTP May'22) (MTP May'23)

On 1st January, 20X1 an entity purchased an item of equipment for ₹ 600,000, including ₹ 50,000 refundable purchase taxes. The purchase price was funded by raising a loan of ₹ 605,000. In addition, the entity has to pay ₹ 5,000 in loan raising fees to the Bank. The loan is secured against the equipment.

In January 20X1 the entity incurred costs of ₹ 20,000 in transporting the equipment to the entity's site and ₹ 100,000 in installing the equipment at the site. At the end of the equipment's 10-year useful life the entity is required to dismantle the equipment and restore the building housing the equipment. The present value of the cost of dismantling the equipment and restoring the building is estimated to be ₹ 100,000.

In January 20X1 the entity's engineer incurred the following costs in modifying the equipment so that it can produce the products manufactured by the entity:

- Materials – ₹ 55,000
- Labour – ₹ 65,000
- Depreciation of plant and equipment used to perform the modifications – ₹ 15,000

In January 20X1, the entity's production staff were trained in how to operate the new item of equipment. Training costs included:

- Cost of an expert external instructor – ₹ 7,000
- Labour – ₹ 3,000

In February 20X1 the entity's production team tested the equipment and the engineering team made further modifications necessary to get the equipment to function as intended by management. The following costs were incurred in the testing phase:

- Materials, net of ₹ 3,000 recovered from the sale of the scrapped output – ₹ 21,000
- Labour – ₹ 16,000

The equipment was ready for use on 1st March, 20X1. However, because of low initial order levels the entity incurred a loss of ₹ 23,000 on operating the equipment during March. Thereafter the equipment operated profitably.

What is the cost of the equipment at initial recognition?

(10 Marks)

Solution:

Description	Calculation or reason	₹
Purchase price	₹ 600,000 purchase price minus ₹ 50,000 refundable purchase taxes	550,000
Loan raising fee	Offset against the measurement of the liability	-
Transport cost	Directly attributable expenditure	20,000
Installation costs	Directly attributable expenditure	100,000
Environmental restoration costs	The obligation to dismantle and restore the environment arose from the installation of	100,000

Preparation costs	the equipment ₹ 55,000 materials + ₹ 65,000 labour + ₹ 15,000 depreciation	135,000
Training costs	Recognised as expenses in profit and loss account. The equipment was capable of operating in the manner intended by management without incurring the training costs.	-
Cost of testing	₹ 21,000 materials (ie net of the ₹ 3,000 recovered from the sale of the scrapped output) + ₹ 16,000 labour	37,000
Operating loss	Recognised as expenses in profit and loss account	-
Borrowing costs	Recognised as expenses in profit and loss account	-
Cost of equipment		9,42,000

Question 7 (RTP May 23)

Company X built a new plant that was brought into use on 1st April, 20X1. The cost to construct the plant was ₹ 1.5 crore. The estimated useful life of the plant is 20 years and Company X accounts for the plant using the cost model. The initial carrying amount of the plant included an amount of ₹ 10 lakh for decommissioning, which was determined using a discount rate of 10%. On 31st March, 20X2, Company X remeasures the provision for decommissioning to ₹ 13 lakh.

Provide necessary journal entries at the end of the year i.e. 31st March, 20X2 for recording of depreciation and decommissioning provision.

Solution:

**Journal Entries in the books of Company X
for the year ending ended 31st March, 20X2**

	₹ in lakh	₹ in lakh
Depreciation (profit or loss) Dr.	7.5	
To Accumulated depreciation (plant)		7.5
(Being depreciation on plant recognised under straight-line method $(1,50,00,000 \times 1/20)$)		
Interest expense (profit or loss) Dr.	1.0	
To Provision for decommissioning		1.0
(Being unwinding of decommissioning provision @10% recognized in the books)		
Plant Dr.	2.0	
To Provision for decommissioning		2.0
(Being increase in decommissioning provision recognized $[13,00,000 - (10,00,000 + 1,00,000)]$ at the end of the year)		

Question 8 (Past Exam May'23)

Note: This Question is same as illustration 12 – Only Grey Highlighted part is the new adjustment

On 1st May, 2022, Sanskar Limited purchased ₹ 42,00,000 worth of land for construction of a new warehouse for stocking new products.

The land purchased had an old temporary structure which was to be demolished for the purpose of construction of warehouse. The salvaged material from the demolition was to be sold as scrap. The company started the construction work of the warehouse on 1st June, 2022. Following costs were incurred by the company with regard to purchase of land and construction of warehouse:

Particulars	Amount (₹)
Legal fees for purchase contract of land and recording ownership	1,50,000
Architect and consultant's fee	2,70,000
Cost of demolishing existing structure on the purchased land	1,35,000
Site preparation charges for the warehouse	1,00,000
Purchase of cement and other materials for the construction (including GST of ₹ 1,00,000 and GST credit is 50% of the payment)	15,00,000
Employment costs of the construction workers	8,00,000
General overhead costs allocated to the construction work	30,000 per month
Overhead costs incurred directly on the construction of warehouse	35,000 per month
Income received from land used as temporary parking during construction phase	80,000

Additional Information:

- Receipt of ₹ 35,000 being proceeds from sale of salvaged and scrapped materials from demolition of existing structure.
- Materials costing ₹ 40,000 was wasted and further ₹ 1,20,000 was spent to rectify the wrong design work.
- The employment costs are for 10 months i.e. from 1st June 2022 till 31st March, 2023.
- The construction of factory was completed on 28th February, 2023 (which is considered as substantial period of time as per Ind AS 23)
- The use of warehouse commenced on 1st March, 2023.
- The overall useful life of factory building was estimated at 25 years from the date of completion; however, it is estimated that the roof of the warehouse will need to be replaced 15 years after the date of completion and that the cost of replacing the roof at current prices would be 25% of the total cost of the building.
- At the end of the 25-year period, Sanskar Limited is legally bound to demolish the factory and restore the site to its original condition. The directors of the company estimate that the cost of demolition in 25 years' time (based on prices prevailing at that time) will be ₹ 80,00,000. An annual risk adjusted discount rate which is appropriate to this project is 10% per annum. The present value of ₹ 1 payable in 25 years' time at an annual discount rate of 10% per annum is ₹ 0.092.
- Sanskar Limited raised a loan of ₹ 60 lakhs @ 10% per annum rate of interest on 1st June, 2022. The building of warehouse meets the definition of a qualifying asset in accordance with Ind AS 23 Borrowing Costs. Sanskar Limited received an investment income of ₹ 25,000 on the temporary investment of the proceeds.
- Assume that cost of demolition of old structure is directly attributable to the cost of land.
- The company follows straight line method of depreciation.

You are required to compute:

- Cost of construction of the warehouse
- Depreciation charge for the year ended 31st March, 2023
- Carrying value of warehouse to be taken to Balance Sheet of the Company on 31st March, 2023.

You should explain your treatment of all the amounts referred to in this question as part of your answer.

(8 Marks)

Solution:

(i) Computation of the cost of construction of the warehouse

Description	Included	Explanation

	In P.P.E. ₹	
Purchase of land	42,00,000	Separately capitalised as cost of land and do not form part of cost of construction of warehouse
Legal fee for purchase of contract of land	1,50,000	Associated legal costs are direct costs for purchasing the land. Hence, separately capitalised as cost of land and do not form part of cost of construction of warehouse
Net cost of demolishing the existing structure	1,00,000	Given in the question to assume it as directly attributable to the cost of land. However, it will be adjusted with the proceeds from sale of salvaged material from demolition (1,35,000 – 35,000). Further, it will be separately capitalized as cost of land and do not form part of cost of construction of warehouse.
Total cost of land	44,50,000	
Architect and consultant's fee	2,70,000	A direct cost of constructing the warehouse
Site preparation charges	1,00,000	
Cement and other materials	14,10,000	A direct cost of constructing the warehouse. Cement and other materials 14,10,000* A direct cost of constructing the warehouse net GST credit and wastage (15,00,000 – 50,000 – 40,000)
Expense to rectify the wrong design work	Nil	Assumed to be abnormal cost
Employment costs of the construction workers	7,20,000	A direct cost of constructing the warehouse for a nine-month period till 28th February, 2023 [(8,00,000/10) x 9]
Direct overhead costs	3,15,000	A direct cost of constructing the warehouse for a nine-month period (35,000 x 9)
Allocated overhead costs	Nil	Not a direct cost of construction
Income from temporary use of land as car parking area	Nil	Not essential to the construction so recognised directly in profit or loss
Finance costs	4,50,000	Capitalise the interest cost incurred in a nine-month period (from 1st June, 2022 to 28th February, 2023)
Investment income on temporary investment of the loan proceeds	(25,000)	Offset against the interest amount capitalised
Demolition cost recognised as a provision	7,36,000	Recognised as part of the initial cost at present value (i.e 80,00,000 x 0.092)
Total cost of construction of a warehouse	39,76,000	

(ii) Computation of depreciation charges for the year ended 31st March, 2023

Note: Land is not depreciated as per Ind AS 16. Hence, only cost of warehouse is subject to depreciation.

Total depreciable amount as on 1st March, 2023	<u>39,76,000</u>	
Depreciation for 1 month must be in two parts:		
(a) Depreciation on roof component	₹5,522	$39,76,000 \times 25\% \times 1/15 \times 1/12$
(b) Depreciation of remaining item ₹	<u>9,940</u>	$39,76,000 \times 75\% \times 1/25 \times 1/12$
Total depreciation for the year 2022-2023	<u>15,462</u>	

(iii) Computation of carrying value of the warehouse on 31st March, 2023 ₹

Cost of the warehouse as on 1st March, 2023 [computed in (i) above]	39,76,000
Less: Depreciation for 1 month as computed in (ii) above	<u>(15,462)</u>
Carrying value of the warehouse as on 31st March, 2023	<u>39,60,538</u>

Alternate Solution

Note: In the above solution, it has been assumed that amount spent for rectifying the faulty design is not included in the cement and other material cost. However, alternatively, it may be considered as part of gross cement and material cost and in such a case, the cost of material will further be reduced with the amount of rectifying the faulty design as follows:

(i) Computation of the cost of construction of the warehouse

Description	Included in P.P.E. ₹	Explanation
Purchase of land	42,00,000	Separately capitalised as cost of land and do not form part of cost of construction of warehouse
Legal fee for purchase of contract of land	1,50,000	Associated legal costs are direct costs for purchasing the land. Hence, separately capitalised as cost of land and do not form part of cost of construction of warehouse
Net cost of demolishing the existing structure	1,00,000	Given in the question to assume it as directly attributable to the cost of land. However, it will be adjusted with the proceeds from sale of salvaged material from demolition (1,35,000 – 35,000). Further, it will be separately capitalised as cost of land and do not form part of cost of construction of warehouse.
Total cost of land	44,50,000	
Architect and consultant's fee	2,70,000	A direct cost of constructing the warehouse
Site preparation charges	1,00,000	A direct cost of constructing the warehouse
Cement and other materials	12,90,000*	A direct cost of constructing the warehouse net GST credit, wastage and rectification cost (15,00,000 – 50,000 – 40,000 – 1,20,000)
Employment costs of the construction workers	7,20,000	A direct cost of constructing the warehouse for a nine-month period till 28th February, 2023 [(8,00,000/10) x 9]
Direct overhead costs	3,15,000	A direct cost of constructing the warehouse for a nine-month period (35,000 x 9)
Allocated overhead costs	Nil	Not a direct cost of construction
Income from temporary use of land as car parking area	Nil	Not essential to the construction so recognised directly in profit or loss
Finance costs	4,50,000	Capitalise the interest cost incurred in a nine-month period (from 1st June, 2022 to 28th February, 2023)
Investment income on temporary investment of the loan proceeds	(25,000)	Offset against the interest amount capitalised
Demolition cost recognised as a provision	7,36,000	Recognised as part of the initial cost at present value (i.e 80,00,000 x 0.092)
Total cost of construction of a warehouse	38,56,000	

(ii) Computation of depreciation charges for the year ended 31st March, 2023

Note: Land is not depreciated as per Ind AS 16. Hence, only cost of warehouse is subject to depreciation.

Total depreciable amount as on 1st March, 2023	38,56,000	
Depreciation for 1 month must be in two parts:		
(a) Depreciation on roof component	5,356	$38,56,000 \times 25\% \times 1/15 \times 1/12$
(b) Depreciation of remaining item	9,640	$38,56,000 \times 75\% \times 1/25 \times 1/12$
Total depreciation for the year 2022-2023	14,996	

(iii) Computation of carrying value of the warehouse on 31st March, 2023

Cost of the warehouse as on 1st March, 2023 [computed in (i) above]	₹ 38,56,000
Less: Depreciation for 1 month as computed in (ii) above	(14,996)
Carrying value of the warehouse as on 31st March, 2023	38,41,004

Question 9 (Past Exam Nov'23)

A shipping company is required by law to bring all its ships into dry dock every 5 years for a major inspection and overhaul. Overhaul expenditure might at first sight seem to be repair to the ships but is actually a cost incurred in getting the ship back into a seaworthy condition. As such the costs must be capitalised.

A ship that cost ₹ 40 Crore with 20-year life must have a major overhaul every 5 years.

The estimated cost of the first overhaul is ₹ 10 Crores.

Calculate:

- the depreciation charged for first five years;
- the carrying amount at the end of 5th year.

(5 Marks)

Solution:

(i) Computation of depreciation charged for the first 5 years

The depreciation charge for the first five years of the asset's life will be as follows:

	Overhaul component (₹ in crores)	Ship (other than overhaul component) (₹ in crores)
Cost	10	30
Years	5	20
Depreciation per year	2	1.50

Total accumulated depreciation for the first five years will be -

$$= (\text{₹ } 2 \text{ crores} + \text{₹ } 1.50 \text{ crores}) \times 5 \text{ years} = \text{₹ } 17.50 \text{ crores}$$

(ii) Computation of carrying amount of the ship at the end of 5th year

$$\text{Carrying amount of the ship at the end of 5th year} = \text{₹ } 40 \text{ crores} - \text{₹ } 17.50 \text{ crores} = \text{₹ } 22.50 \text{ crores}$$

IND AS 19 – EMPLOYEE BENEFITS

Illustration 1 - Vested Accumulating Benefits

Mr. Rajan is working for Infotech Ltd. Consider the following particulars: Annual salary of Mr. Rajan = ₹ 30,00,000

Total working days in 20X0-X1 = 300 days

Leaves allowed in 20X0-X1 as per company policy = 10 days

Leaves utilized by Mr. Rajan in 20X0-X1 = 8 days

The unutilized leaves are settled by way of payment and accordingly, carry forward of such leaves to the subsequent period is not allowed.

Compute the total employee benefit expense for Infotech Ltd. in respect of 20X0-X1.

Solution

Mr. Rajan is entitled to a salary of ₹ 30,00,000 for 300 total working days.

Thus, per day salary works out to ₹ 30,00,000 ÷ 300 days = Rs. 10,000 per day

In the year 20X0-20X1, Mr. Rajan availed 8 out of 10 leaves allowed by the company. Accordingly, leaves unutilized = 10 – 8 = 2 days

In line with the company policy, Infotech Ltd. will pay Mr. Rajan for the unutilized leave.

Thus, total expense for 20X0-20X1 = ₹ 30,00,000 + (2 days unutilized leaves × ₹ 10,000 per day) = ₹ 30,20,000.

Illustration 2 - Non-Vested Accumulating Benefits – (MTP – April, 2021)

Mr. Niranjan is working for Infotech Ltd. Consider the following particulars:

	Year 20X0-20X1	Year 20X1-20X2
Annual salary	₹ 30,00,000	₹ 30,00,000
No. of working days during the year	300 days	300 days
Leave allowed	10 days	10 days
Leave taken	7 days	13 days
Leave unutilized carried forward to next year	3 days	NIL

Based on past experience, Infotech Ltd. assumes that Mr. Niranjan will avail the unutilized leaves of 3 days of 20X0-20X1 in 20X1-20X2.

Infotech Ltd. contends that it will record ₹ 30,00,000 as employee benefits expense in each of the years 20X0-20X1 and 20X1-20X2, stating that the leaves will, in any case, be utilized by 20X1-20X2.

Comment on the accounting treatment proposed to be followed by Infotech Ltd. Also pass journal entries for both the years. (8 Marks)

Solution:

Particulars	Year 20X0 - 20X1	Year 20X1 - 20X2
Annual Salary	₹ 30,00,000	₹ 30,00,000
No. of working days (A)	300 days	300 days
Leaves Allowed	10 days	10 days
Leaves Taken (B)	7 days	13 days

Therefore, No. of days worked (A – B)	293 days	287 days
Expense proposed to be recognized by Infotech Ltd.	₹ 30,00,000	₹ 30,00,000

Based on the evaluation above, Mr. Niranjana has worked for 6 days more (293 days – 287 days) in 20X0-20X1 as compared to 20X1-20X2.

Since he has worked more in 20X0-20X1 as compared to 20X1-20X2, the accrual concept requires that the expenditure to be recognized in 20X0-20X1 should be more as compared to 20X1-20X2.

Thus, if Infotech Ltd. recognizes the same expenditure of ₹ 30,00,000 for each year, it would be in violation of the accrual concept.

The expenditure to be recognized will be as under:

Particulars	Year 20X0-20X1	Year 20X1-20X2
Annual salary (A)	₹ 30,00,000	₹ 30,00,000
No. of working days (B)	300 days	300 days
Salary cost per day (A ÷ B)	₹ 10,000 per day	₹ 10,000 per day
No. of days worked (from above)	293 days	287 days
Expense to be recognised:		
In 20X0-20X1: ₹ 30,00,000 + [₹ 10,000 per day x 3 days (leaves unutilized expected to be utilized subsequently)]	₹ 30,30,000	
In 20X1-20X2: ₹ 30,00,000 – [₹ 10,000 per day – 3 days (excess leave utilized in 20X1-20X2)]		₹ 29,70,000

Journal Entry for 20X0-20X1

Employee Benefits Expense Account	Dr.	30,30,000	
To Bank Account			30,00,000
To Provision for Leave Encashment			30,000

Journal Entry for 20X1-20X2

Employee Benefits Expense Account	Dr.	29,70,000	
Provision for Leave Encashment Account	Dr.	30,000	
To Bank Account			30,00,000

Illustration 3 - Non-Vested Accumulating Benefits

Assume same information as in Illustration 2.

Based on past experience, Infotech Ltd. assumes that Mr. Niranjana will avail the unutilized leaves of 2 days of 20X0-20X1 subsequently.

However, in 20X1-20X2, Mr. Niranjana availed in actual all 3 days of brought forward leave.

Compute the expense to be recognised in 20X0-20X1 and 20X1-20X2. Also pass journal entries for both the years.

Solution:

The expenditure to be recognized will be as under:

Particulars	Year 20X0-20X1	Year 20X1-20X2
Annual salary (A)	₹ 30,00,000	₹ 30,00,000
No. of working days (B)	300 days	300 days

Salary cost per day (A + B)	₹ 10,000 per day	₹ 10,000 per day
No. of days worked (from above)	293 days	287 days
Expense to be recognised: In 20X0-20X1: ₹ 30,00,000 + [₹ 10,000 per day x 2 days (leaves unutilized expected to be utilized subsequently)]	₹ 30,20,000	
In 20X1-20X2: ₹ 30,00,000 – [₹ 10,000 per day x 3 days (excess leave utilized in 20X1- 20X2)] + ₹ 10,000 (additional expense due to change in accounting estimate)		₹ 29,80,000

The additional ₹ 10,000 booked as an expense in 20X1-20X2 represents a change in accounting estimate (i.e. as against the entity's estimation that 2 days of unutilized leave would be utilized subsequently, actually 3 days were utilized subsequently), for which a prospective effect needs to be given, in line with Para 36 of Ind AS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

Journal Entry for 20X0-20X1

Employee Benefits Expense Account	Dr.	30,20,000
To Bank Account		30,00,000
To Provision for Leave Encashment		20,000

Journal Entry for 20X1-20X2

Employee Benefits Expense Account	Dr.	29,80,000
Provision for Leave Encashment Account	Dr.	20,000
To Bank Account		30,00,000

Illustration 4

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

Type of leave (A)	Leave Entitlement (B)	Leaves c/f permissible (C)	Average leaves Unutilized (D)	No. of Employees (E)	Liability (F = D x E)
Casual Leave	30 days	10 days	5 days	30	150 days salary
Sick Leave	10 days	2 days	1 days	10	10 days salary

The entity will recognise liability in the books equal to 150 (30 x 5) days of casual leave and 10 (10 x 1) days of sick leave.

Illustration 5

An entity has 100 employees, who are each entitled to ten working days of paid sick leave for each year. Unused sick leave may be carried forward for one financial 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 (a LIFO basis).

At 31 March 20X1, the average unused entitlement is two days per employee. Based on past experience, the management expects that only 20% of the employees will use 1 day from their carried forward leave. Salary per day is ₹ 2,500.

Compute the expenses in respect of the short-term compensated absences, if they are assumed to be (a) vested short-term compensated absences, and (b) non-vested short-term compensated absences.

Solution:

Vested short-term compensated absences:

Employee Benefit Expense = 100 Employees x 2 Days x ₹ 2,500 = ₹ 5,00,000

Non-vested short-term compensated absences:

Employee Benefit Expense = 100 Employees x 20% x 1 Days x ₹ 2,500 = ₹ 50,000

Illustration 6

Acer Ltd. has 350 employees (same as a year ago). The average staff attrition rates observed during past 10 years represents 6% per annum. Acer Ltd. provides the following benefits to all its employees:

Paid vacation - 10 days per year regardless of date of hiring. Compensation for paid vacation is 100% of employee's salary and unused vacation can be carried forward for 1 year. As of 31st March, 20X1, unused vacation carried forward was 3 days per employee, average salary was ₹ 15,000 per day and accrued expense for unused vacation in 20X0-20X1 was ₹ 65,00,000. During 20X1-20X2, employees took 9 days of vacation in average. Salary increase in 20X1-20X2 was 10%.

How would Acer Ltd. recognize liabilities and expenses for these benefits as of 31st March, 20X2? Pass the journal entry to show the accounting treatment.

Solution:

Paid Vacation:

Step 1: Calculation of Unused Vacation in man-days as on 31st March, 20X2:

A. No. of Employees in service for the whole year (94%):

Particulars	Man-days
Unused vacation as on 31 st March, 20X1	3 days per employee
Entitlement to vacation for 20X1-20X2	10 days per employee
Average vacation availed in 20X1-20X2	<u>(9) days per employee</u>
Unused vacation as on 31st March, 20X2 (being unused leaves of 20X1-20X2 on FIFO basis)	4 days per employee
Total Unused vacation as on 31st March, 20X2 - (A) (350 employees x 94% x 4 days per employee)	1,316 man-days

B. Newcomers (6%):

Particulars	Man-days
Entitlement to vacation for 20X1-20X2	10 days per employee
Average vacation availed in 20X1-20X2	<u>(9) days per employee</u>

Unused vacation as on 31 st March, 20X2 (being unused leaves of 20X1-20X2 on FIFO basis)	1 day per employee
Total Unused vacation as on 31 st March, 20X2 - (B) (350 employees x 6% x 1 day per employee)	21 man-days
Total unused vacation as on 31 st March, 20X2 (A + B)	1,337 man-days

Step 2: Calculation of average salary per day:

Particulars	Amount (₹)
Average salary per day as on 31 st March, 20X1	15,000
Salary increase in 20X1-20X2	10%
Average salary per day as on 31 st March, 20X2	16,500

Step 3: Calculation of provision for unused paid vacation:

Particulars	Amount (₹)
Calculation of provision for unused paid vacation 20X1-20X2: (1,337 man-days x ₹ 16,500)	2,20,60,500
Provision for unused paid vacation 20X0-20X1	65,00,000

Step 4: Accounting treatmentProvision for 20X1-20X2

Employee Benefits Expenses A/c	Dr.	2,20,60,500	
To Provision for Leave Encashment			2,20,60,500

Settlement of Liability of 20X0-20X1

Provision for Leave Encashment A/c	Dr.	65,00,000	
To Cash / Bank			65,00,000

Illustration 7

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. As under these KINDs of plans, 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 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 make a provision for liability and recognise the same amount as an expense of the amount of ₹ 9 crores in 20X1-20X2 (4.5% of ₹200 crores).

Illustration 8

Acer Ltd. has 350 employees (same as a year ago). The average staff attrition rates as observed during past 10 years represents 6% per annum. Acer provides the following benefits to all its employees:

Annual bonus - during past 10 years.

Acer paid bonus to all employees who were in service during the entire financial year. Bonus was paid in June following the financial year-end. Amount of bonus for 20X1-20X2 paid in June 20X2 represented ₹

1,25,000 per employee. Acer Ltd. used to increase amount of bonus based on official inflation rate which is 8.5% for 20X2-20X3, although there was no legal obligation to increase the bonus by such inflation rate.

How would Acer Ltd. recognize liabilities and expenses for these employee benefits as on 31st March, 20X3? Pass the journal entry to show the accounting treatment.

Solution:

Particulars	Amount (₹)
Bonus paid for 20X1-20X2	1,25,000 per employee
Bonus for 20X2-20X3 - increased by inflation of 8.5%: $[1,25,000 \times (100\% + 8.5\%)]$	1,35,625 per employee
No. of employees in staff during the whole year $[350 \times (100-6\%)]$	329 employees
Provision for Bonus for 20X2-20X3	4,46,20,625

Accounting Treatment:

Provision for Bonus for 20X2-20X3

Employee Benefits Expenses A/c Dr. 4,46,20,625

To Provision for Bonus 20X2-20X3 4,46,20,625

Note:

It is given that the company is under no legal obligation to increase the bonus by the official inflation rate. However, the company has been increasing the bonus by the inflation rate over the past years. This has given rise to a constructive obligation for Acer Ltd. Informal practices, such as these, give rise to a constructive obligation where the entity has no realistic alternative but to pay employee benefits. Accordingly, provision is made for the amount considering the inflation rate.

Illustration 9

A company pays each employee a lump-sum one-time benefit upon retirement. This benefit is computed based on the employee's years in service in the company and the final salary prior to retirement. To cover its liabilities from this remuneration, the company contributes 3% of annual gross salaries to the fund. Would this obligation represent a defined contribution plan or a defined benefit plan and why?

Solution:

Defined benefit plan.

Reason: Although the Company pays contributions to the fund to cover its liabilities, amount of remuneration is determined in advance and Company will have to carry the risk in case the fund's assets are not sufficient to cover remuneration in full.

Illustration 10

In accordance with applicable legislation, company contributes 12% and employees 12% of annual gross salaries to the provident and pension fund. Upon retirement, the employees will get the accumulated balance that is calculated based on employee's years of service and his average salary for past 15 years before retirement. The pension will be paid out of the state fund assets and the company has no further obligation except to make contributions. Would this obligation represent a defined contribution plan or a defined benefit plan?

Solution:

Defined contribution plan.

Reason: Although employee's pension is determined in advance by the formula (and thus employees neither carry actuarial nor investment risks), Company's liability is limited to contributions to the fund. In this case, as pension will be paid out of the state fund, it is a state fund which carries all the risks.

Illustration 11

Acer Ltd. provides lump-sum remuneration upon retirement to its employees. Remuneration is paid out of the fund to which Acer Ltd. contributes 12% of annual gross salaries. Contributions are made twice a year i.e. in November of the related financial year and in June after the financial year-end. Total annual gross salaries for 20X0-X1 amounted to ₹ 50 crores. Contribution made by Acer Ltd. in November 20X0 was ₹ 2.8 crores. Remuneration depends on the number of employee's service and amount of cash in the fund at retirement date (Acer Ltd. has no further obligations except for contributions).

How should this transaction appear in the financial statements of Acer Ltd. as of 31 March 20X1?

Solution:

1. Calculation of accrual for contributions in 20X0-20X1:

Annual gross salaries in 20X0-20X1:	₹ 50.00 crores
Amount of total contributions for 20X0-20X1 (12%):	₹ 6.00 crores
Contributions already made in November 20X0:	₹ 2.80 crores
Accrual (₹ 6 crores - ₹ 2.8 crores)	₹ 3.20 crores

2. Accounting Treatment:

Employee Benefits Expenses Account	Dr.	6.00 crores
To Bank Account		2.80 crores
To Contribution Payable		3.20 crores

The contribution of ₹ 6 crores will be debited to the statement profit and loss. The contribution payable of ₹ 3.20 crores will appear as a liability as at 31st March, 20X1.

Illustration 12

Dinkar Ltd., a large IT company, accounts for gratuity on payment basis, and supports such accounting policy by making the following disclosure in the Financial Statements:

"Due to high labour turnover, a large degree of uncertainty is involved in estimating the liability of gratuity. Accordingly, the management opines that as the estimates of the uncertainty would confuse the readers by complicating the financial statements, such liability would be recorded on payment basis."

The management opines that by making the above disclosures, the company is complying with the requirements of all the Ind AS, as a disclosure to the effect of the above is given. The management is also willing to specifically highlight the above aspect by making it conspicuous in the financial statements.

Is the contention of management correct as per the provisions of Ind AS?

Solution:

Gratuity represents a payment being made to an employee upon retirement / resignation from the organization. The amount is determined in accordance with the provisions of the Gratuity Act, 1972, which applies to Dinkar Ltd. Since the amount is determined pursuant to a formula laid down under the statute, the gratuity payable represents a Defined Benefit Plan that is to be paid to the employees, with the actuarial

risk and investment risk both belonging to the employer. Thus, Dinkar Ltd. must comply with Ind AS 19 and provide for the gratuity on an annual basis.

In estimating the liability for gratuity, there would be several assumptions involved such as mortality rate, staff attrition rate, salary at the time of retirement / resignation, discount rate etc., all of which have to be considered by Dinkar Ltd. The complexity involved in this exercise does not provide Dinkar Ltd. with an excuse to avoid accrual accounting.

Dinkar Ltd. has stated that it would be willing to make a disclosure to the effect of the departure from Ind AS 10 requirements. In terms of Para 19 of Ind AS 1, departure is permitted in **extremely rare** circumstances wherein the management concludes that compliance with an Ind AS requirement would be so **misleading** that it would **conflict** with the objective of the Financial Statements set out in the Framework.

In the given case, compliance with Ind AS would not be a conflict, as the compliance with Ind AS 19 would ensure that the accrual assumption laid down in the Framework is complied with. Further, a disclosure cannot be a remedy for non-compliance. Therefore, the company have to state that the Ind AS have not been complied with by the company in the preparation and presentation of its Financial Statements.

Hence, the company will have to suitably modify the financial statements considering the materiality and pervasiveness of the non-compliance.

Illustration 13

How will the following information be presented in the Balance Sheet of Udyog Ltd.?

Particulars	₹ in lakhs
PV of Defined Benefit Obligations	3,500
Fair Value of Plan Assets	3,332

Solution:

Particulars	₹ in lakhs
PV of Defined Benefit Obligations	3,500
Less: Fair Value of Plan Assets	(3,332)
Deficit, to be treated as Net Defined Benefit Liability under Non-current Liabilities as Provisions in the Balance Sheet	<u>168</u>

Illustration 14

How will the following information be presented in the Balance Sheet of Udyog Ltd.?

Particulars	₹ in lakhs
PV of Defined Benefit Obligations	2,750
Fair Value of Plan Assets	2,975
Asset Ceiling	175

Solution:

Particulars	₹ in lakhs
PV of Defined Benefit Obligations	2,750
Less: Fair Value of Plan Assets	(2,975)

Surplus, to be treated as Net Defined Benefit Asset,	225
Asset Ceiling as per Ind AS 19	175
Least of above is Surplus to be treated as Net Defined Benefit Asset under Balance Sheet	175

Illustration 15 – (MTP May'24)

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

- benefits attributed (year on year) and
- the obligation in respect of this benefit (year on year)

For an 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.
- (6 Marks)

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

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	11,449	12,250	13,108
		(10,000 x 107%)	(10,700 x 107%)	(11,449 x 107%)	(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	98	108	119	131
	(131 x E)	(131 x E)	(131 x E)	(131 x E)	(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.

Illustration 16

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) A benefit of ₹150 is attributed to each year.
- b) 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.
This is because the benefits vest at a future date (i.e. after ten years of service).

Illustration 17

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

- a) 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).
- b) A benefit of ₹ 150 is attributed to each subsequent year. There is no requirement to reflect any probability of completion as the benefits vest immediately

Illustration 18

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 to the employee. However, such kind of plan will provide no further benefit for subsequent service. Compute the benefit attributed for last 10 years and after these years?

Solution

1. In this case, as per the company's plan, a benefit of ₹200 ($₹2,000 / 10$) is attributed to each of the first ten years.
2. The current service cost in each of the first ten years reflects the probability that the employee may not complete ten years of service. This is because the benefits vest at a future date (i.e. after ten years of service).
No benefit is attributed to subsequent years.

Illustration 19

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 20

A post-employment medical plan reimburses 40 percent 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 per cent of those costs if the employee leaves after twenty or more years of service. How will the benefit be attributed to the years of service?

Solution:

1. Under the Plan's Benefit Formula, the entity should attribute 4% of the present value of the expected medical costs ($40\% \div 10$ years) to each of the first ten years, and 1% ($10\% \div 10$ years) to each of the second ten years.
2. For employees expected to leave within 10 years, no benefit is attributed.
3. The Current Service Cost in each year reflects the probability that the employee may not complete the necessary period of service to earn part or all of the benefits

Illustration 21

A post-employment medical plan reimburses 10 percent 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 per cent of those costs if the employee leaves after twenty or more years of service.

How will the benefit be attributed to the years of service?

Solution:

1. Service in later years will lead to a materially higher level of benefit than in earlier year. So, for employees expected to leave after 20 or more years, the entity should attribute benefit on a straight-line basis under Para 71. Service beyond 20 years will lead to no material amount of further benefits. So, the benefit attributed to each of the first 20 years will be 2.5% of the Present Value of the Expected Medical Costs ($50\% \div 20$ years).
2. For employees expected to leave between 10 and 20 years, the benefit attributed to each of the first 10 years is 1% ($10\% \div 10$ years) 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.
3. For employees expected to leave within ten years, no benefit is attributed.

4. The Current Service Cost in each year reflects the probability that the employee may not complete the necessary period of service to earn part or all of the benefits.

Illustration 22

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.

Illustration 23

Pratap Ltd. belongs to the ship-building industry. The company reviewed an Actuarial Valuation for the first time for its pension scheme which revealed a surplus of ₹ 60 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to ₹ 20 lakhs instead of ₹ 50 lakhs.

The average remaining life of the employees is estimated to be 6 years. Advise the Company in line with Ind AS 19.

Solution:

- 1. Recognition:** As per Ind⁴ AS 19, any Actuarial Gains and Losses should be recognized as a re-measurement of the Net Defined Benefit Liability / (Asset) in "Other Comprehensive Income".
- 2. Measurement and Presentation:** In the given case, the amount of surplus from Pension Scheme of ₹ 60 lakhs is an Actuarial Gain and should be recognized as a "re-measurement" in "Other Comprehensive Income", and not to be adjusted from the amount of annual contribution in future years.
- 3. Disclosure:** The change relating to Actuarial Valuation for the Pension Scheme requires disclosure under Ind AS 8. Disclosures required by Ind AS 19 should also be made in the financial statements.

Illustration 24 (MTP May'23, Nov'23)

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 –

- 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.
- Give the journal entries in respect of amount(s) to be recognized.

(8 Marks)

Solution

- Extract of the Balance Sheet of RKA Private Ltd as at 31st March, 20X2 ₹ in lacs Closing net defined liability (1,580 – 1,275) 305 lacs

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

- Journal entries in the books of RKA Private Ltd

Particulars	₹ in lacs	₹ in lacs

Profit & Loss Dr.	76	
Other comprehensive incomeDr.	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

= $8\% \times (1,400 - 1,140)$ lacs

= $8\% \times 260$ lacs

= 21 lacs (Rounded off to nearest lacs)

2. Computation of Remeasurements**Defined Benefit Obligation Account**

Particulars	₹ in lacs	Particulars	₹ in lacs
To balance c/d (given) (closing balance)	1,580	By balance b/d (given) (opening balance)	1,400
		By Current Service Cost (given)	55
		By Interest on Opening Liability (1,400 x 8%)	112
		By Actuarial loss (bal. figure)	13
	<u>1,580</u>		<u>1,580</u>

OR

Statement to calculate 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	<u>1,580</u>

Plan Assets Account

Particulars	₹ in lacs	Particulars	₹ in lacs
To balance b/d (given) (opening balance)	1,140	By balance c/d (given) (closing balance)	1,275
To Bank Account (contribution for the year)	111		
To Surplus / Actual Return (bal. figure)	24		
	<u>1,275</u>		<u>1,275</u>

OR

Statement to calculate 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

Illustration 25

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?

Solution:

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.

Illustration 26

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?

Solution

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.

Illustration 27

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?

Solution

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.

Illustration 28

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 attributed for last 20 years, 10 and 20 years and within 10 years?

Solution

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.

Illustration 29 – (Past Exam Nov'20) (MTP March'22)

Cisca Pvt. Ltd. has a headcount of around 1,000 employees in the organisation in 20X0-20X1. As per the company policy, the employees are given 35 days of privilege leave (PL), 15 days of sick leave (SL) and 10 days of casual leave. Out of the total PL and sick leave, 10 and 5 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 as PL and 5 as 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 the nature of defined contribution plan where contribution to this 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 for the short-term compensating absences, profit-sharing plan and the defined contribution plan by Cisca Pvt. Ltd? (6 Marks)

Solution

(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 ($2,000 \times 3.5\%$) as a liability and expense it 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.

Illustration 30

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?

Solution:

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.

Illustration 31

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).

Solution:

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

Illustration 32 - (RTP - May 2019) + (RTP - Nov 2018)

A Ltd. prepares its financial statements to 31st March each year. It operates a defined benefit retirement benefits plan on behalf of current and former employees. A Ltd. receives advice from actuaries regarding contribution levels and overall liabilities of the plan to pay benefits. On 1st April, 20X1, the actuaries advised that the present value of the defined benefit obligation was ₹ 6,00,00,000. On the same date, the fair value of the assets of the defined benefit plan was ₹ 5,20,00,000. On 1st April, 20X1, the annual market yield on government bonds was 5%. During the year ended 31st March, 20X2, A Ltd. made contributions of ₹ 70,00,000 into the plan and the plan paid out benefits of ₹ 42,00,000 to retired members. Both these payments were made on 31st March, 20X2.

The actuaries advised that the current service cost for the year ended 31st March, 20X2 was ₹ 62,00,000. On 28th February, 20X2, the rules of the plan were amended with retrospective effect. These amendments meant that the present value of the defined benefit obligation was increased by ₹ 15,00,000 from that date.

During the year ended 31st March, 20X2, A Ltd. was in negotiation with employee representatives regarding planned redundancies. The negotiations were completed shortly before the year end and redundancy packages were agreed. The impact of these redundancies was to reduce the present value of the defined benefit obligation by ₹ 80,00,000. Before 31st March, 20X2, A Ltd. made payments of ₹ 75,00,000 to the employees affected by the redundancies in compensation for the curtailment of their benefits. These payments were made out of the assets of the retirement benefits plan.

On 31st March, 20X2, the actuaries advised that the present value of the defined benefit obligation was ₹ 6,80,00,000. On the same date, the fair value of the assets of the defined benefit plan were ₹ 5,60,00,000.

Examine and present how the above event would be reported in the financial statements of A Ltd. for the year ended 31st March, 20X2 as per Ind AS. Finance cost is to be computed on the opening balances.

Solution:

All figures are ₹ in '000.

On 31st March, 20X2, A Ltd. will report a net pension liability in the statement of financial position. The amount of the liability will be 12,000 (68,000 – 56,000).

For the year ended 31st March, 20X2, A Ltd. will report the current service cost as an operating cost in the statement of profit or loss. The amount reported will be 6,200. The same treatment applies to the past service cost of 1,500.

For the year ended 31st March, 20X2, A Ltd. will report a finance cost in profit or loss based on the net pension liability at the start of the year of 8,000 (60,000 – 52,000). The amount of the finance cost will be 400 (8,000 x 5%).

The redundancy programme represents the partial settlement of the curtailment of a defined benefit obligation. The gain on settlement of 500 (8,000 – 7,500) will be reported in the statement of profit or loss.

Other movements in the net pension liability will be reported as remeasurement gains or losses in other comprehensive income.

For the year ended 31st March, 20X2, the remeasurement loss will be 3,400 (Refer W. N.).

Working Note:

Remeasurement of gain or loss

	₹ in '000
Liability at the start of the year (60,000 – 52,000)	8,000
Current service cost	6,200
Past service cost	1,500
Net finance cost	400
Gain on settlement	(500)
Contributions to plan	(7,000)
Remeasurement loss (balancing figure)	3,400
Liability at the end of the year (68,000 – 56,000)	12,000

Illustration 33 - (RTP May'20) (MTP May'20, Oct'20), (Past Exam May'22)

On 1 April 20X1, the fair value of the assets of XYZ Ltd's defined benefit plan were valued at ₹ 20,40,000 and the present value of the defined obligation was ₹ 21,25,000. On 31st March, 20X2 the plan received contributions from XYZ Ltd amounting to ₹ 4,25,000 and paid out benefits of ₹ 2,55,000. The current service cost for the financial year ending 31 March 20X2 is ₹ 5,10,000. An interest rate of 5% is to be applied to the plan assets and obligations. The fair value of the plan's assets at 31 March 20X2 was ₹ 23,80,000, and the present value of the defined benefit obligation was ₹ 27,20,000.

Provide a reconciliation from the opening balance to the closing balance for Plan assets and Defined benefit obligation. Also show how much amount should be recognised in the statement of profit and loss, other comprehensive income and balance sheet? **(7 Marks)**

Solution:

Reconciliation of Plan assets and Defined benefit obligation

	Plan Assets ₹	Defined benefit obligation ₹
Fair value/present value as at 1 st April 20X1	20,40,000	21,25,000
Interest @ 5%	1,02,000	1,06,250
Current service cost		5,10,000
Contributions received	4,25,000	-
Benefits paid	(2,55,000)	(2,55,000)
Return on gain (assets) (balancing figure)	68,000	-
Actuarial Loss (balancing figure)	-	2,33,750
Closing balance as at March 31, 20X2	23,80,000	27,20,000

In the Statement of Profit and loss, the following will be recognised:

Current service cost	₹ 5,10,000
Net interest on net defined liability (₹ 1,06,250 – ₹ 1,02,000)	4,250

Defined benefit re-measurements recognised in Other Comprehensive Income:

Loss on defined benefit obligation	₹ (2,33,750)
Gain on plan assets	68,000
	(1,65,750)

In the Balance sheet, the following will be recognised :

Net defined liability (₹ 27,20,000 – ₹ 23,80,000)	₹ 3,40,000

Question 1 (RTP May'19)

ABC Limited operates a defined benefit plan which provides to the employees covered under the plan a pension benefit which is equal to 0.75% final salary for each year of completed service. An employee needs to complete minimum of five years' service for becoming eligible to the benefit. On 1st April, 2015, the entity improves the pension benefit to 1% of final salary for each year of service, including prior years. The present value of the defined benefit obligation is therefore, increased by ₹ 80 million. Given below is the composition of this amount:

Employees with more than 5 years' of service at 1 st April, 2015	60 million
Employees with less than 5 years' of service at 1 st April, 2015	20 million

The employees in the second category have completed average 2 and half years of service. Hence, they need to complete another two and half year of service until vesting.

Comment on the treatment of ₹ 80 million of the defined benefit obligation in the financial statements as per Ind AS 19.]

Solution

Under Ind AS 19, the entire past service cost of 80 million needs to be recognized and charged in profit or loss immediately.

Question 2 (RTP May'21)

At 1 April, 20X0, the fair value of the Plan Assets was ₹ 10,00,000. The Plan paid benefits of ₹ 1,90,000 and received contributions of ₹ 4,90,000 on 30 September, 20X0. The company computes the Fair Value of Plan Assets to be ₹ 15,00,000 as on 31 March, 20X1 and the Present Value of the Defined Benefit Obligation to amount to ₹ 14,79,200 on the same date. Actuarial losses on defined benefit obligation were ₹ 6,000. Compounding happens half-yearly. The normal interest rate for 6 months period is 10% per annum, while the effective interest rate for 12 months period is based on the following data:

At 1 April, 20X0, the company made the following estimates based on market prices at that date:

Particulars	%
Interest and Dividend Income, after tax payable by the fund	9.25
Add: Realized and Unrealized Gains on Plan Assets (after tax)	2.00
Less: Administration Costs	(1.00)
Expected Rate of Return	10.25

Determine actual return and expected return on plan asset. Also compute amount to be recognized in 'Other Comprehensive Income' in this case.

Solution:**Computation of Expected Return on Plan Assets**

Particulars	₹
Return on ₹ 10,00,000 for 20X0-20X1 at 10.25% = ₹ 10,00,000 x 10.25%	1,02,500
Add: Return on ₹ 3,00,000 for 6 months at 10% Normal Rate = [3,00,000 (Inflow ₹ 4,90,000 less Payments ₹ 1,90,000) x 10% x 6/12]	15,000
Expected Return on Plan Assets	1,17,500

Computation of Actual Return on Plan Assets

Particulars	₹
Fair Value of Plan Assets at the year-end – 31 March 20X1	15,00,000
Less: Fair Value of Plan Assets at the beginning – 1 April 20X0	(10,00,000)
Less: Contributions received during the year 20X0-20X1	(4,90,000)
Add: Benefits paid during the year 20X0-20X1	1,90,000
Actual Return on Plan Assets	2,00,000

Computation of Net Actuarial Gain

Particulars	₹
Actual Return on Plan Assets	2,00,000
Less: Expected Return on Plan Assets	(1,17,500)
Actuarial Gain on Plan Assets	82,500
Less: Actuarial Loss on Defined Benefit Obligation (given)	(6,000)
Net Actuarial Gain to be recognized in 'Other Comprehensive Income'	76,500

Question 3 (RTP May 23)

From the following particulars, compute the net defined benefit liability and expense to be recognized in Profit and Loss account. (₹ in lakhs)

Particulars	Defined benefit obligation		Plan Assets	
	31st Dec. 20X2	31st Dec. 20X1	31st Dec. 20X2	31st Dec. 20X1
Balance at the beginning of the year	63.25	47.08	21.80	14.65
Current service cost	5.84	4.97	-	-
Interest cost	4.27	3.56	-	-
Changes in demographic assumptions	0.62	1.86	-	-
Changes in financial assumptions	3.58	1.93	-	-
Experience variance	(2.49)	4.46	-	-
Benefits paid	-	(0.61)	-	(0.61)
Investment income	-	-	1.47	1.12
Employers' contribution	-	-	8.00	7.00
Return on plan assets	-	-	2.12	(0.35)

Solution:

Computation of defined benefit liability and expenses to be charged to Statement of Profit and Loss:

	Defined benefit	Plan Assets (₹ in lakhs)

	obligation (₹ in lakhs)			
	31st Dec 20X2	31st Dec 20X1	31st Dec 20X2	31st Dec 20X1
Balance at the beginning of year	63.25	47.08	21.80*	14.65
Current service cost	5.84	4.97	-	-
Interest cost	4.27	3.56	-	-
Changes in demographic assumptions	0.62	1.86	-	-
Changes in financial assumptions	3.58	1.93	-	-
Experience variance	(2.49)	4.46	-	-
Benefits paid	-	(0.61)	-	(0.61)
Investment income	-	-	1.47	1.12
Employers' contribution	-	-	8.00	7.00
Return on plan assets	-	-	2.12	(0.35)
Balance at the end of year	75.07	63.25	33.39	21.81*

*Difference is due to approximation.

In the **BALANCE SHEET**, the following will be recognised:

Net defined liability to be recognised for the period ending 31st December, 20X1:

$$= ₹ 41.44 \text{ lakhs } (₹ 63.25 \text{ lakhs} - ₹ 21.81 \text{ lakhs})$$

Net defined liability to be recognised for the period ending 31st December, 20X2:

$$= ₹ 41.68 \text{ lakhs } (₹ 75.07 \text{ lakhs} - ₹ 33.39 \text{ lakhs})$$

In the **STATEMENT OF PROFIT AND LOSS**, the following will be recognised:

	Defined benefit obligation (₹ in lakhs)		Plan Assets (₹ in lakhs)	
	31st Dec., 20X2	31st Dec., 20X1	31st Dec., 20X2	31st Dec., 20X1
Current service cost	5.84	4.97	-	-
Interest cost	4.27	3.56	-	-
Investment income	-	-	(1.47)	(1.12)
Total	10.11	8.53	(1.47)	(1.12)

Expense to be recognised in the Statement of Profit and Loss for the period ending 31st December, 20X1 = ₹ 7.41 lakhs (₹ 8.53 lakhs - ₹ 1.12 lakhs)

Expense to be recognised in the Statement of Profit and Loss for the period ending 31st December, 20X2 = ₹ 8.64 lakhs (₹ 10.11 lakhs - ₹ 1.47 lakhs).

Question 4 (RTP Nov'23)

Arunachalam Ltd. operates a Defined Retirement Benefits Plan for its current and former employees. Given the large size of the company, it engaged a firm of Actuaries for advice on the Contribution Levels and overall Liabilities of the Plan to pay benefits.

Following details are given: *

- On 1st April, 20X1, the actuarial valuation of the present value of the defined benefit obligation was ₹ 15 crores. On the same date, the fair value of the assets of the Defined Benefit Plan was ₹ 13 crores. On 1st April, 20X1, the annual market yield based on Government Bonds was 5%.
- During the year ended 31st March, 20X2, Arunachalam made contributions of ₹ 1.75 crore into the Plan and the Plan paid out benefits of ₹ 1.05 crore to retired members. Assume that both these payments were made on 31st March, 20X2.
- The Actuarial Firm estimated that the current service cost for the year ended 31st March, 20X2 would be ₹ 1.55 crores. On 28th February, 20X2, the rules of the Plan were amended with retrospective effect which led to an increase in the present value of the defined benefit obligation by ₹ 37.5 lakhs from that date.
- During the year ended 31st March, 20X2, Arunachalam was in negotiation with employee representatives regarding planned redundancies. These negotiations were completed shortly before the year end and the redundancy packages were agreed. The impact of these redundancies was to reduce the present value of the defined benefit obligation by ₹ 2 crores. Before 31st March, 20X2, Arunachalam made payments of ₹ 1.875 crores to the employees affected by the redundancies in compensation for a curtailment of their benefits. These payments were made out of the assets of the Retirement Benefits Plan.
- On 31st March, 20X2, the present value of the defined benefit obligation was ₹ 17 crores and the fair value of the assets of the Defined Benefit Plan was ₹ 14 crores.

Discuss how the above will be accounted in the books of Arunachalam Ltd. for the year 20X1-20X2. Also give the extracts of financial statements affected due to above transactions.

Solution:

1. Extract of Balance Sheet (Net Amount in the Balance Sheet)

	(₹ in lakhs)	
	31.3.20X2	1.4.20X1
PV of Defined Benefit Obligation (given)	(1,700.00)	(1,500.00)
FV of Plan Assets (given)	<u>1,400.00</u>	<u>1,300.00</u>
Net Defined Benefit Liability (under Long-term Provision)	<u>(300.00)</u>	<u>(200.00)</u>

2. Extract of Statement of Profit and Loss

	(₹ in lakhs)
Current service cost (given)	155.00
Past service cost (given)	37.50
Gain on settlement (₹ 200 lakhs – ₹ 187.50 lakhs)	(12.50)
Net interest on net defined benefit liability [₹ 75 lakhs - ₹ 65 lakhs]	<u>10.00</u>
Total to Statement of Profit and Loss	<u>190.00</u>

3. Extract of Other Comprehensive Income (Remeasurements)

	(₹ in lakhs)
Actuarial loss on defined benefit obligation (W.N.1)	(237.50)
Return on plan assets other than expected return (W.N.2)	<u>152.50</u>
Total	<u>(85.00)</u>

Working Notes:

1. Defined Benefit Obligation Account

Particulars	₹ in lakhs	Particulars	₹ in lakhs
To Plan Assets (benefits paid)	105.00	By Balance b/f (given) [balance as on 1.4.20X1]	1,500.00
To Curtailment and Settlement	200.00	By Current Service Cost	155.00
To Balance c/d (given) [balance as on 31.3.20X2]	1,700.00	By Interest Cost [5% on Opening balance]	75.00
		By Past service cost	37.50
		By Actuarial Loss (balancing figure)	237.50
	2,005.00		2,005.00

2. Plan Assets Account

Particulars	₹ in lakhs	Particulars	₹ in lakhs
To Balance b/f (given) [balance as on 1.4.20X1]	1,300.00	By Defined Benefit Obligation [benefits paid]	105.00
To Expected Return [5% on Opening balance]	65.00	By Payments on curtailment and settlement	187.50
To Bank (contributions paid)	175.00	By Balance c/d (given) [balance as on 31.3.20X2]	1,400.00
To Actuarial Gain (balancing figure)	152.50		
	1,692.50		1,692.50

The above Defined Benefit Obligation Account and Plan Assets Account can alternatively be presented in a statement form as follows:

Defined Benefit Obligation		Plan Assets	
Particulars	₹ in lakhs	Particulars	₹ in lakhs
PV of Obligation b/f.	1,500.00	FV of Plan Assets b/f.	1,300.00
Interest Cost [₹ 1,500 x 5%]	75.00	Interest Income [₹ 1,300 x 5%]	65.00
Current Service Cost	155.00	Contribution during 20X1- 20X2	175.00
Benefits paid during 20X1-20X2	(105.00)	Benefits paid during 20X1- 20X2	(105.00)
Plan Curtailment and Settlement	(200.00)	Payment towards settlement	(187.50)
Past Service Cost	37.50		
Remeasurement Loss (balancing figure)	<u>237.50</u>	Remeasurement Gain (balancing figure)	<u>152.50</u>
PV of Obligation c/f.	<u>1,700.00</u>	FV of Plan Assets c/f.	<u>1,400.00</u>

Question 5 (RTP Nov'23)

On 1st January, 20X2, the directors of Johansen Ltd. decided to terminate production at one of the company's divisions. This decision was publicly announced on 31st January, 20X2. The activities of the division were gradually reduced from 1st April, 20X2 and closure is expected to be complete by 30th September, 20X2.

At 31st January, 20X2, the directors prepared the following estimates of the financial implications of the closure:

- (i) Redundancy costs were initially estimated at ₹ 2 million. Further expenditure of ₹ 8,00,000 will be necessary to retrain employees who will be affected by the closure but remained with Johansen Ltd. in different divisions. This retraining will begin in early July 20X2. Latest estimates are that redundancy costs will be ₹ 1.9 million, with retraining costs of ₹ 8,50,000.
- (ii) Plant and equipment having an expected carrying value at 31st March, 20X2 of ₹ 8 million will have a recoverable amount ₹ 1.5 million. These estimates remain valid.
- (iii) The division is under contract to supply goods to a customer for the next three years at a pre-determined price. It will be necessary to pay compensation of ₹ 6,00,000 to this customer. The compensation actually paid, on 31st May, 20X2, was ₹ 5,50,000.
- (iv) The division will make operating losses of ₹ 3,00,000 per month in the first three months of 20X2-20X3 and ₹ 2,00,000 per month in the next three months of 20X2-20X3. This estimate proved accurate for April, 20X2 and May, 20X2.
- (v) The division operates from a leasehold premise. The lease is a non-cancellable operating lease with an unexpired term of five years from 31st March, 20X2. The annual lease rentals (payable on 31st March in arrears) are ₹ 1.5 million. The landlord is not prepared to discuss an early termination payment.

Following the closure of the division it is estimated that Johansen Ltd. would be able to sub-let the property from 1st October, 20X2.

Johansen Ltd. could expect to receive a rental of ₹ 3,00,000 for the six-month period from 1st October, 20X2 to 31st March, 20X3 and then annual rentals of ₹ 5,00,000 for each period ending 31st March, 20X4 to 31st March, 20X7. All rentals will be received in arrears.

Any discounting calculations should be performed using a discount rate of 5% per annum. You are given the following data for discounting at 5% per annum:

Present value of ₹ 1 received at the end of year 1 = ₹ 0.95

Present value of ₹ 1 received at the end of year 1–2 inclusive = ₹ 1.86

Present value of ₹ 1 received at the end of year 1–3 inclusive = ₹ 2.72

Present value of ₹ 1 received at the end of year 1–4 inclusive = ₹ 3.54

Present value of ₹ 1 received at the end of year 1–5 inclusive = ₹ 4.32

Compute the amounts that will be included in the Statement of Profit and Loss for the year ended 31st March, 20X2 in respect of the decision to close the division of Johansen Ltd.

Solution:

As per Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets', closure of a division is a restructuring exercise. Ind AS 37 states that a constructive obligation to proceed with the restructuring arises when at the reporting date the entity has:

- Commenced activities connected with the restructuring; or
- Made a public announcement of the main features of the restructuring to those affected by it. In this case a public announcement has been made and so a provision will be necessary at 31st March, 20X2.

This will result in the following charges to the Statement of Profit and Loss:

- (i) Estimate of redundancy costs of ₹ 1.9 million is the best estimate of the expenditure at the date the financial statements are authorized for issue. Changes in estimates after the reporting date are taken into account for this purpose as an adjusting event after the reporting date. No charge is necessary for the retraining costs as these are not incurred in 20X1-20X2 and cannot form part of a restructuring provision as they are related to the ongoing activities of the entity.

- (ii) Impairment of plant and equipment of ₹ 6.5 million is although not strictly part of the restructuring provision the decision to restructure before the year-end means that related assets need to be reviewed for impairment. In this case the recoverable amount of the plant and equipment is only ₹ 1.5 million. As per Ind AS 36 'Impairment of Assets', property, plant and equipment should be written down to this amount, resulting in a charge of ₹ 6.5 million to the income statement.
- (iii) For compensation for breach of contract of ₹ 0.55 million, same principle applies here as applied to the redundancy costs.
- (iv) No charge is recognized in 20X1-20X2 with respect to future operating losses of 20X2-20X3. Future operating losses relate to future events and provisions are made only for the consequences of past events.
- (v) Ind AS 37 states that an onerous contract is one for which the expected cost of fulfilling the contract exceeds the benefits expected from the contract. Provision is made for the lower of the expected net cost of fulfilling the contract and the cost of early termination (not available in this case).

The net cost of fulfilling the contract is ₹ 4.51 million [₹ 1.5 million x 4.32 – ₹ 0.3 million x 0.95 – ₹ 0.5 million x (4.32 – 0.95)].

IND AS 20 – ACCOUNTING FOR GOVERNMENT GRANTS AND DISCLOSURE OF GOVERNMENT ASSISTANCE

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 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 recognised assuming that A Pharmaceuticals Limited has reasonable assurance that the conditions attached to the grant will be complied with.

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 recognised.

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.

Illustration 4

A Limited received from the government a loan of ₹50,00,000 @ 5% payable after 5 years in a bullet 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)

Working Note:

Particulars	Amount (₹)	DF @12%	Present value(₹)
Interest @ 5% for Year 1 on loan amount of 50 lakhs	2,50,000	0.893	2,23,214
Interest @ 5% for Year 2 on loan amount of 50 lakhs	2,50,000	0.797	1,99,298
Interest @ 5% for Year 3 on loan amount of 50 lakhs	2,50,000	0.712	1,77,945
Interest @ 5% for Year 4 on loan amount of 50 lakhs	2,50,000	0.636	1,58,880
Interest @ 5% for Year 5 on loan amount of 50 lakhs	2,50,000	0.567	1,41,857
Loan	50,00,000	0.567	28,37,134
Present value of loan at the beginning of Year 1			37,38,328

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:

- the loan is an immediate relief measure to rescue the enterprise
- the loan is a subsidy for staff training expenses, incurred equally, for a period of 4 years
- 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.

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 $[(₹100,000 - ₹10,000) \times 5]$ 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 $(₹10,000 \times 5)$.

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.

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 investing activities.

Illustration 9 (RTP May 23)

A Ltd. received a government grant of ₹ 10,00,000 to defray expenses for environmental protection. Expected environmental costs to be incurred is ₹ 3,00,000 per annum for the next 5 years. How should A Ltd. present such grant related to income in its financial statements?

Solution:

As per paragraph 29 of Ind AS 20, 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.

In accordance with the above, presentation of grants related to income under both the methods are as follows:

Method 1: Credit in the statement of profit and loss

The entity can recognise the grant as income on a straight line basis i.e., ₹ 2,00,000 per year in the statement of profit and loss either separately or under the head „Other Income“.

The supporters of this method consider it inappropriate to present income and expense items on a net basis and that „separation of the grant from the expense facilitates comparison with other expenses not affected by a grant“.

Method 2: As a deduction in reporting the related expense

Since the grant relates to environmental expenses incurred/to be incurred by the entity, it can present the grant by reducing the grant amount every year from the related expense i.e., environmental expense of ₹ 1,00,000 (i.e., net expense ₹ 3,00,000 – ₹ 2,00,000).

The supporters of this method are of the view that „the expenses might well not have been incurred by the entity if the grant had not been available and presentation of the expense without offsetting the grant may therefore be misleading“.

The Standard regards both the methods as acceptable for the presentation of grants related to income. However, method 2 may be more appropriate when the company can relate the grant to a specific expenditure.

The Standard also provides that 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.

Illustration 10

A Ltd. has received a grant of ₹ 10,00,00,000 in the year 20X1-20X2 from local government in the form of subsidy for selling goods at lower price to lower income group population in a particular area for two years. A Ltd. had accounted for the grant as income in the year 20X1-20X2. While accounting for the grant in the year 20X1-20X2, A Ltd. was reasonably assured that all the conditions attached to the grant will be complied with. However, in the year 20X5-20X6, it was found that A Ltd. has not complied with the above condition and therefore notice of refund of grant has been served to it. A Ltd. has contested but lost in court in 20X5-20X6 and now grant is fully repayable. The accounting done in previous years was not incorrect and was not an error as per Ind AS 8. How should A Ltd. reflect repayable grant in its financial statements ending 20X5-20X6?

Solution:

Note: It is being assumed that the accounting done in previous years was not incorrect and was not in error as per Ind AS 8.

Paragraph 32 of Ind AS 20, states that a Government grant that becomes repayable shall be accounted for as a change in accounting estimate (see Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors).

Repayment of a grant related to income shall be applied first against any unamortised deferred credit recognised in respect of the grant. To the extent that the repayment exceeds any such deferred credit, or when no deferred credit exists, the repayment shall be recognised immediately in profit or loss.

Repayment of a grant related to an asset shall be recognised by increasing the carrying amount of the asset or reducing the deferred income balance by the amount repayable. The cumulative additional

depreciation that would have been recognised in profit or loss to date in the absence of the grant shall be recognised immediately in profit or loss.

The following journal entries should be passed:

S. No.	Particulars	Nature of Account	Dr./Cr.	Amount (₹ in crores)
(i)	Repayment of Government Grant To Grant repayable (Being recognition of repayment of grant in statement of profit or loss)	Expense (P/L) Balance sheet (Liability)	Dr.	10 10
(ii)	Grant repayable To Bank (Being grant refunded)	Balance sheet (Liability) Balance sheet (Asset)	Dr.	10 10

Assuming that no deferred credit balance exists in the year 20 X5-20X6, therefore repayment recognised in P&L.

Illustration 11

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?

Solution

ABC Ltd. should recognise the grants in the following manner:

- 20 lakhs has 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) every year.

Illustration 12

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.

Solution

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.

Working Note

Particulars	₹	DF @12%	PV (₹)
Interest @ 5% for Year 1 on loan amount of 1 crore	5,00,000	0.893	4,46,429
Interest @ 5% for Year 2 on loan amount of 1 crore	5,00,000	0.798	3,98,597
Interest @ 5% for Year 3 on loan amount of 1 crore	5,00,000	0.712	3,55,890
Interest @ 5% for Year 4 on loan amount of 1 crore	5,00,000	0.636	3,17,759
Interest @ 5% for Year 5 on loan amount of 1 crore	5,00,000	0.567	2,83,713
Loan	1,00,00,000	0.567	56,74,269
Present value of loan at the beginning of Year 1			74,76,656

The above present value above has been computed on full scale basis

Illustration 13

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 Grant related to asset or
- A Grant related to income?

Solution

Paragraph 3 of IND AS 20, Government Grants and Disclosure of Government Assistance, 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

It is pertinent to note that the classification of the grant as related to asset or income will require exercise of judgement and careful examination of the facts, objective and conditions attached to the scheme of the government. Care is also required to ascertain the purpose of the grant and the costs for which the grant is intended to compensate. Based on the evaluation of facts, if it is ascertained that the grant is an asset related grant then the same shall be presented as per paragraphs 24 and 26 of Ind AS 20 which has been stated below

Presentation of grants related to assets

As per para 24, 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.

As per para 26, the grant set up as deferred income is recognised in profit or loss on a systematic basis over the useful life of the asset.

If it is determined that the grant is related to income then the same shall be presented as follows:

Presentation of grants related to income

As per para 29, 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.

It may be further noted that as per paragraph 12 of Ind AS 20, government grants shall be accounted as follows:

As per para 12, 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.

In the given case, if 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; recognition of grant in the statement of profit and loss should be linked to fulfilment of associated export obligations.

However, if the grant received is to compensate the import cost of the asset and based on the examination of the terms and conditions of the grant, if it can be reasonably concluded that conditions relating to export of goods are subsidiary conditions, then it is appropriate to recognise such grant in profit or loss over the life of the underlying asset.

Illustration 14 – (RTP MAY'18)

ABC Ltd is a government company and is a first-time adopter of Ind AS. As per the previous GAAP, the contributions received by ABC Ltd. from the government (which holds 100% shareholding in ABC Ltd.) which is in the nature of promoters' contribution have been recognised in capital reserve and treated as part of shareholders' funds in accordance with the provisions of AS 12, Accounting for Government Grants.

State whether the accounting treatment of the grants in the nature of promoters' contribution as per AS 12 is also permitted under Ind AS 20 Accounting for Government Grants and Disclosure of Government Assistance.

Solution

Paragraph 2 of Ind AS 20, "Accounting for Government Grants and Disclosure of Government Assistance" inter alia states that the Standard does not deal with government participation in the ownership of the entity.

Since ABC Ltd. is a Government company, it implies that government has 100% shareholding in the entity. Accordingly, the entity needs to determine whether the payment is provided as a shareholder contribution or as a government. Equity contributions will be recorded in equity while grants will be shown in the Statement of Profit and Loss.

Where it is concluded that the contributions are in the nature of government grant, the entity shall apply the principles of Ind AS 20 retrospectively as specified in Ind AS 101 'First Time Adoption of Ind AS'. Ind AS 20 requires all grants to be recognised as income 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. Unlike AS 12, Ind AS 20 requires the grant to be classified as either a capital or an income grant and does not permit recognition of government grants in the nature of promoter's contribution directly to shareholders' funds.

Illustration 15 - (RTP May'20) (MTP March'21)

Rainbow Limited is carrying out various projects for which the company has either received government financial assistance or is in the process of receiving the same. The company has received two grants of ₹ 1,00,000 each, relating to the following ongoing research and development projects:

(i) The first grant relates to the "Clean river project" which involves research into the effect of various chemicals waste from the industrial area in Madhya Pradesh. However, no major steps have been completed by Rainbow limited to commence this research as at 31st march, 20X2.

(ii) The second grant relates to the commercial development of a new equipment that can be used to manufacture eco-friendly substitutes for existing plastic products. Rainbow Limited is confident about the technical feasibility and financial viability of this new technology which will be available for sale in the market by April 20X3.

(iii) In September 20X1, due to the floods near one of its factories, the entire production was lost and Rainbow Limited had to shut down the factory for a period of 3 months. The State Government announced a compensation package for all the manufacturing entities affected due to the floods. As per the scheme, Rainbow Limited is entitled to a compensation based on the average of previous three months' sales figure prior to the floods, for which the company is required to submit an application form on or before 30th June, 20X2 with necessary figures. The financial statements of Rainbow Limited are to be adopted on 31st May, 20X2, by which date the claim form would not have been filed with the State Government.

Suggest the accounting treatment of, if any, for the two grants received and the flood - related compensation in the books of accounts of Rainbow Limited as on 31st March, 20X2. (6 Marks)

Solution

Accounting treatment for:

1. First Grant

The first grant for 'Clear River' Project involving research into effects of various chemicals waste from the industrial area in Madhya Pradesh, seems to be unconditional as no details regarding its refund has been mentioned. Even though the research has not been started nor any major steps have been completed by Rainbow Limited to commence the research, yet the grant will be recognised immediately in profit or loss for the year ended 31st March, 20X2.

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

2. Second Grant

The second grant related to commercial development of a new equipment is a grant related to depreciable asset. As per the information given in the question, the equipment will be available for sale in the market from April, 20X3. Hence, by that time, grant relates to the construction of an asset and should be initially recognised as deferred income.

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

The entity should recognise a liability on the balance sheet for the years ending 31st March, 20X2 and 31st March, 20X3. Once the equipment starts being used in the manufacturing process, the deferred grant income of ₹ 100,000 should be recognised over the asset's useful life to compensate for depreciation costs.

Alternatively, as per Ind AS 20, Rainbow Limited would also be permitted to offset the deferred income of ₹ 100,000 against the cost of the equipment as on 1st April, 20X3.

3. For flood related compensation

Rainbow Limited will be able to submit an application form only after 31st May, 20X2 i.e. in the year 20X2-20X3. Although flood happened in September, 20X1 and loss was incurred due to flood related to the year 20X1-20X2, the entity should recognise the income from the government grant in the year when the application form related to it is submitted and approved by the government for compensation.

Since, in the year 20X1-20X2, the application form could not be submitted due to adoption of financials with respect to sales figure before flood occurred, Rainbow Limited should not recognise the grant income as it has not become receivable as on 31st March, 20X2.

Illustration 16 – (MTP May'23, RTP Nov'23)

An entity opens a new factory and receives a government grant of ₹ 15,000 in respect of capital equipment costing ₹ 1,00,000. It depreciates all plant and machinery at 20% per annum on straight-line basis. Show the statement of profit and loss and balance sheet extracts in respect of the grant for first year under both the methods as per Ind AS 20. (6 Marks)

Solution:

(a) When grant is treated as deferred income

Statement of profit and loss – An extract

	₹
Depreciation (₹ 1,00,000 x 20%)	(20,000)
Government grant credit (W.N.1)	3,000

Balance Sheet - An extract

		₹
Non-current assets		
Property, plant and equipment	1,00,000	
Less: Accumulated depreciation	(1,00,000 x 20%) (20,000)	80,000

		Xxxx
Non-current liabilities		
Government grant	[12,000 – 3,000 (current liability)]	9,000
Current liabilities		
Government grant	(15,000 x 20%)	<u>3,000</u>
		Xxxx

Working Note:

1. Government grant deferred income account

	₹		₹
To Profit or loss	3,000	By Grant cash received	15,000
(15,000 x 20%)			
To Balance c/f	<u>12,000</u>		
	<u>15,000</u>		<u>15,000</u>

(b) When grant is deducted from cost of the asset**Statement of profit and loss – An extract**

	₹
Depreciation [(₹ 1,00,000 – 15,000) x 20%]	(17,000)

Balance Sheet - An extract

		₹
Non-current assets		
Property, plant and equipment	(1,00,000-15,000) 85,000	
Less: Accumulated depreciation	(17,000)	68,000

Illustration 17 – (Past Exam – May 2022)

A company receives a cash grant of ₹ 30,000 on 31 March 20X1. The grant is towards the cost of training young apprentices. Training programme is expected to last for 18 months starting from 1 April 20X1. Actual costs of the training incurred in 20X1-20X2 was ₹ 50,000 and in 20X2-20X3 ₹ 25,000. State, how this grant should be accounted for? **(4 Marks)**

Solution:

At 31st March 20X1 the grant would be recognised as a liability and presented in the balance sheet as a split between current and non-current amounts.

₹ 20,000 [(12 months / 18 months) x 30,000] is current and would be recognised in profit and loss for the year ended 31st March, 20X1. The balance amount of ₹ 10,000 will be shown as non-current.

At the end of year 20X1-20X2, there would be a current balance of 10,000 (being the non-current balance at the end of year 20X1-20X1 reclassified as current) in the balance sheet. This would be recognised in profit in the year 20X2-20X3.

Extracts from the financial statements are as follows:

Balance Sheet (extracts)

	31 March 20X1	31 March 20X2	31 March 20X3

Current liabilities			
Deferred income	20,000	10,000	-
Non-current liabilities			
Deferred income	10,000	-	-

Statement of profit and loss (extracts)

	31 March 20X2	31 March 20X3
Method 1		
Other Income - Government grant received	20,000	10,000
Training costs	(50,000)	(25,000)
Method 2		
Training costs (50,000 – 20,000)	30,000	
Training costs (25,000 – 10,000)		15,000

Illustration 18 – (RTP Nov'20, MTP Nov'21), (Past Exam May'22)

Entity A is awarded a government grant of ₹60,000 receivable over three years (₹40,000 in year 1 and ₹10,000 in each of years 2 and 3), contingent on creating 10 new jobs and maintaining them for three years. The employees are recruited at a total cost of ₹30,000, and the wage bill for the first year is ₹1,00,000, rising by ₹10,000 in each of the subsequent years. Calculate the grant income and deferred income to be accounted for in the books for the years 1, 2 and 3 under the following two situations:

- There is reasonable assurance that the entity will comply with the conditions attaching to them and the grant will be received
- There is no reasonable assurance that the grant will be received.

Solution:**a) When there is reasonable assurance**

The grant of 60,000 should be recognised at the beginning of the first year as receivable and will be compensated for the related costs over three years.

The initial journal entry would be:

Grant Receivable Ac Dr. 60,000
To Deferred Income A/c 60,000

The income of ₹ 60,000 should be recognised over three year period to compensate for the related costs.

Calculation of grant income and deferred income:

Year	Labour Cost	Grant Income	Computation of Grant Income	Deferred Income at the end of the year	Computation of deferred income at the end of the year
	₹	₹		₹	
1	1,30,000	21,667	60,000 x (130/360)	38,333	(60,000 – 21,667)
2	1,10,000	18,333	60,000 x (110/360)	20,000	(38,333 – 18,333)
3	1,20,000	20,000	60,000 x (120/360)	-	(20,000 – 20,000)
	<u>3,60,000</u>	<u>60,000</u>			

Therefore, grant income to be recognised in the Statement of Profit and Loss for the years 1, 2 and 3 would be ₹ 21,667, ₹ 18,333 and ₹ 20,000 respectively.

The amount of grant that has not yet been credited to the statement of profit and loss i.e. deferred income is to be shown in the balance sheet. Hence deferred income balance as at end of year 1, 2 and 3 are ₹ 38,333, ₹ 20,000 and Nil respectively

b) When reasonable assurance is not there

The grant of 60,000 should be recognised over three years to compensate for the related costs.

The journal entry on receipt of grant at year 1 would be:

Grant Receivable Ac Dr. 40,000

To Deferred Income A/c 40,000

Calculation of Grant Income and Deferred Income:

Year	Labour Cost	Grant Income	Computation of Grant Income	Deferred Income at end of year	Computation of deferred income at end of year
	₹	₹		₹	
1	1,30,000	21,667	$60,000 \times (130/360)$	18,333	$(40,000 - 21,667)$
2	1,10,000	18,333	$60,000 \times (110/360)$	10,000	$(50,000 - 21,667 - 18,333)$
3	1,20,000	20,000	$60,000 \times (120/360)$	-	$(60,000 - 21,667 - 18,333 - 20,000)$
	3,60,000	60,000			

Therefore, Grant income to be recognised in Profit & Loss for years 1, 2 and 3 are ₹ 21,667, ₹ 18,333 and ₹ 20,000 respectively.

Amount of grant that has not yet been credited to profit & loss i.e; deferred income is to be reflected in the balance sheet. Hence, deferred income balance as at year end 1, 2 and 3 are ₹ 18,333, ₹ 10,000 and Nil respectively.

Question 1 – (Past Exam - Nov '18) + (MTP - Oct 2020)

How will you recognize and present the grants received from the Government in the following cases as per Ind AS 20?

- (i) A Ltd. received one acre of land to setup a plant in backward area (fair value of land ₹ 12 lakh and acquired value by Government is ₹ 8 lakhs).
- (ii) B Ltd. received an amount of loan for setting up a plant at concessional rate of interest from the Government.
- (iii) D Ltd. received an amount of ₹ 25 lakh for immediate start-up of a business without any condition.
- (iv) S Ltd. received ₹ 10 lakh for purchase of machinery costing ₹ 80 lakh. Useful life of machinery is 10 years. Depreciation on this machinery is to be charged on straight line basis.
- (v) Government gives a grant of ₹ 25 lakh to U Limited for research and development of medicine for breast cancer, even though similar medicines are available in the market but are expensive. The company is to ensure by developing a manufacturing process over a period of two years so that the cost comes down at least to 50%. **(5 Marks)**

Solution:

i) The land and government grant should be recognized by A Ltd. at fair value of ₹ 12,00,000 and this government grant should be presented in the books as deferred income.

Alternatively, if the company is following the policy of recognising non-monetary grants at nominal value, the company will not recognise any government grant. Land will be shown in the financial statements at ₹ 1)

(ii) As per para 10A of Ind AS 20 'Accounting for Government Grants and Disclosure of Government Assistance', loan at concessional rates of interest is to be measured at fair value and recognised as per Ind AS 109. Value of concession is 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 as Government grant.

(iii) ₹ 25 lakh has been received by D Ltd. for immediate start-up of business. Since this grant is given to provide immediate financial support to an entity, it should be recognised in the Statement of Profit and Loss immediately with disclosure to ensure that its effect is clearly understood, as per para 21 of Ind AS 20.

(iv) ₹ 10 lakh should be recognized by S Ltd. as deferred income and will be transferred to profit and loss over the useful life of the asset. In this case, ₹ 1,00,000 [₹ 10 lakh / 10 years] should be credited to profit and loss each year over period of 10 years. Alternatively, if the company is following the policy of recognising non-monetary grants at nominal value, the company will not recognise any government grant. The machinery will be recognised at ₹ 70 lakh (₹ 80 lakh - ₹ 10 lakh). Reduced depreciation will be charged to the Statement of Profit or Loss.

(v) As per para 12 of Ind AS 20, the entire grant of ₹ 25 lakh should be recognized immediately as deferred income and charged to profit and loss over a period of two years based on the related costs for which the grants are intended to compensate provided that there is reasonable assurance that U Ltd. will comply with the conditions attached to the grant.

Question 2 – RTP (Dec 2021)

A Ltd. has been conducting its business activities in backward areas of the country and due to higher operating costs in such regions, it has collectively incurred huge losses in previous years. As per a scheme of government announced in March 20X1, the company will be partially compensated for the losses incurred by it to the extent of ₹ 10,00,00,000, which will be received in October 20X1. The compensation being paid by the government meets the definition of government grant as per Ind AS 20. Assume that no other conditions are to be fulfilled by the company to receive the compensation.

When should the grant be recognised in statement of profit and loss? Discuss in light of relevant Ind AS.

Solution

Paragraph 7 of Ind AS 20 states that, Government grants, including non-monetary grants at fair value, shall not be recognised until there is reasonable assurance that:

- (e) the entity will comply with the conditions attaching to them; and
- (f) the grants will be received.

Further, paragraphs 20 and 22 of Ind AS 20 state as follows:

"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 shall be recognised in profit or loss of the period in which it becomes receivable".

"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."

In accordance with the above, in the given case, as at March 20X1, A Ltd. is entitled to receive government grant in the form of compensation for losses already incurred by it in the previous years. Therefore, even though the compensation will be received in the month of October 20X1, A Ltd. should recognise the compensation receivable by it as a government grant in the profit or loss for the period in which it became receivable, i.e., for the financial year 20X0-20X1 with disclosure to ensure that its effect is clearly understood.

Question 3 (RTP May'22), (MTP Nov'22)

A Limited is engaged in the manufacturing of certain specialized chemicals. During the manufacturing process, certain wastewater is produced which is released by A Limited in the nearby river. To reduce pollution of the rivers, the state government has introduced a scheme with the following salient features:

- If a manufacturer installs certain pre-approved wastewater treatment plant, the government will provide an interest free loan equal to 50% of the cost of the plant;
- Such loan will be repayable to the government in 5 years from the date of disbursement;
- The manufacturer availing the benefit of this scheme must treat the wastewater of its factory using the specified plant before releasing it to the river. If this condition is violated, the entire loan shall become immediately repayable to the government along with a penalty of ₹ 10 lakh.

Cost of the wastewater treatment plant to be installed to avail the benefit of the scheme is ₹ 50 lakh. A Limited decided to utilise this scheme because, if it were to obtain the similar loan from a bank, it would be available at a market interest rate of 12% per annum. Accordingly, A Limited applied for and obtained the government loan of ₹ 25 lakh on 1st April, 20X1. A Limited purchased and installed the plant such that it became ready for use on the same date.

A Limited has an accounting policy of recognising government grant in relation to depreciable assets in the proportion of depreciation expense. It has determined that the plant will be depreciated over a period of 5 years using straight-line method. In the month of March, 20X3, government officials conducted a surprise audit, and it was found that A Limited was not using the wastewater treatment plant as prescribed. Accordingly, on 31st March, 20X3, the government ordered A Limited to repay the entire loan along with penalty. A Limited repaid the loan with interest and penalty as per the order on 31st March, 20X3.

Measure the amount of government grant as on 1st April, 20X1. Determine the nature of the government grant and its accounting treatment (principally) for the year ended 31st March, 20X2. Also determine the impact on profit or loss if any, on account of revocation of government grant as on 31st March, 20X3.

(12 Marks)

Solution:

As per the principles of Ind AS 20 "Accounting for Government Grants and Disclosure of Government Assistance", the benefits of a government loan at a below market rate of interest is treated as a government

grant. The loan shall be recognized and measured in accordance with Ind AS 109 "Financial Instruments". The benefit of the below market rate of interest shall 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. As per Ind AS 109, the loan should be initially measured at its fair value.

Initial recognition of grant as on 1st April, 20X1

Fair value of loan = ₹ 25,00,000 × 0.567 (PVF @ 12%, 5th year) = ₹ 14,17,500

A Limited will recognize ₹ 10,82,500 (25,00,000 – 14,17,500) as the government grant and will make the following entry on receipt of loan:

Date	Particulars	Dr. (₹)	Cr. (₹)
1.4.20X1	Bank account Dr. To Deferred Grant Income To Loan account (Being grant initially recorded at fair value)	25,00,000	10,82,500 14,17,500

Accounting treatment for year ending 31st March, 20X2

As per para 3 of Ind AS 20, 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.

As per para 24-27 of Ind AS 20, Government grants related to assets, including non-monetary grants at fair value, shall be presented in the balance sheet either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset.

One method recognises the grant as deferred income that is recognised in profit or loss on a systematic basis over the useful life of the asset.

The other method deducts the grant in calculating the carrying amount of the asset. The grant is recognised in profit or loss over the life of a depreciable asset as a reduced depreciation expense.

A Ltd. has adopted first method of recognising the grant as deferred income that is recognised in profit or loss on a systematic basis over the useful life of the asset. Here, deferred income is recognised in profit or loss in the proportion in which depreciation expense on the asset is recognised.

Depreciation for the year (20X1-20X2) = ₹ 50,00,000 / 5 years = ₹ 10,00,000

As the loan is to finance a depreciable asset, ₹ 10,82,500 will be recognized in Profit or Loss on the same basis as depreciation.

Since the depreciation is provided on straight line basis by A Limited, it will credit ₹ 2,16,500 (10,82,500 / 5) equally to its statement of profit and loss over the 5 years.

Date	Particulars	Dr. (₹)	Cr. (₹)
31.3.20X2	Depreciation (Profit or Loss A/c) Dr. To Property, Plant & Equipment (Being depreciation provided for the year)	10,00,000	10,00,000
	Deferred grant income Dr. To Profit or Loss (Being deferred income adjusted)	2,16,500	2,16,500

Impact on profit or loss due to revocation of government grant as on 31st March 20X3

As per para 32 of Ind AS 20, a government grant that becomes repayable shall be accounted for as a change in accounting estimate. Repayment of a grant related to income shall be applied first against any unamortised deferred credit recognised in respect of the grant. To the extent that the repayment exceeds any such deferred credit, or when no deferred credit exists, the repayment shall be recognised immediately in profit or loss.

Amount payable to Government on account of principal loan = ₹ 25,00,000

Amount payable to Government on account of penalty = ₹ 10,00,000

Journal Entries

Date	Particulars	Dr. (₹)	Cr. (₹)
31.3.20X3	Deferred grant income To Profit or Loss (Being deferred income adjusted)	Dr. 2,16,500	2,16,500
	Loan account (W.N.1) Deferred grant income (W.N.2) Profit or Loss To Government grant payable (Being refund of government grant)	Dr. Dr. Dr. 17,78,112 6,49,500 72,388	25,00,000
	Profit or Loss To Government grant payable (Being penalty payable to government)	Dr. 10,00,000	10,00,000

Therefore, total impact on profit or loss on account of revocation of government grant as on 31st March, 20X3 will be ₹ 10,72,388 (10,00,000 + 72,388).

Circumstances giving rise to repayment of a grant related to an asset may require consideration to be given to the possible impairment of the new carrying amount of the asset.

Working Notes:

1. Amortisation Schedule of Loan

Year	Opening balance of Loan	Interest @ 12%	Closing balance of Loan
31.03.20X2	14,17,500	1,70,100	15,87,600
31.03.20X3	15,87,600	1,90,512	17,78,112

2. Deferred Grant Income

Year	Opening balance	Adjustment	Closing balance
31.03.20X2	10,82,500	2,16,500	8,66,000
31.03.20X3	8,66,000	2,16,500	6,49,500

Question 4 (MTP April'22)

M Limited had constructed another factory few years ago with the assistance of yet another government grant, 'Innovative Product'. The grant is non-repayable and, following the construction of the factory, cannot be clawed back by the government. There are no further conditions attached to the grant that the Company is required to satisfy. The grant received has been treated as deferred income and is being credited to the income statement over the same period as the factory is being depreciated. Following an adverse change in the demand of the product the factory manufactures, during the year at the reporting date, the directors have concluded that the factory's carrying value is no longer recoverable in full and that a write down for impairment is required. The write down is more than covered by the amortized deferred income balance related to the grant.

Discuss, in the context of Ind AS framework and Ind AS 20, the impairment of the factory for which 'Innovative Product' government grant, has been received. Would your answer be different, if there are further conditions attached to grant beyond construction of factory? (6 Marks)

Solution:

Accounting treatment for Government Grant:

Government grants, related to assets, including non-monetary grants at fair value should be presented in the Balance Sheet either by setting up the grant as deferred income or by deducting the grant in arriving at the asset's carrying amount. (Para 24 of Ind AS 20)

Government grants should be recognised as income over the periods in which the entity recognises as expenses the related costs that they are intended to compensate, on a systematic basis. The outcome should be same in the Profit and Loss account statement regardless of whether grants are netted or deferred.

In case the grant had been offset against the acquisition cost of the factory and net carrying value is less than the recoverable amount, there would be no need for an impairment write-down. The Profit and Loss account would be charged with annual depreciation on the net acquisition cost.

Government grant relating to 'Innovative Product':

To match the same result for the grant 'Innovative Product' which has been shown as deferred income and the factory is initially recorded at its cost, it is reasonable to release an amount of deferred income to the Profit and Loss account to compensate for the impairment write-down.

Treatment in case of further conditions attached:

If there are further conditions attached to the grant beyond construction of the factory, it may not be appropriate to release an amount of the deferred income to compensate for the impairment write down. An entity would need to assess those further conditions to determine the amount, if any, of deferred income to release.

Question 5 (RTP Nov'22)

To encourage entities to expand their operations in a specified development zone, the government provides interest-free loans to fund the purchase of manufacturing equipment.

In accordance with the development scheme, an entity receives an interest-free loan of ₹ 5,00,000 from the government for a period of three years. The market rate of interest for similar loans for 3 years is 5% per year.

There are no future performance conditions attached to the interest-free loan.

Discuss how to account for the above loan. Pass necessary journal entries in the entity's books of accounts from year 1 to year 3, as per relevant Ind AS.

Solution:

The entity measures the loan on initial recognition at ₹ 4,32,000, which is the present value of the loan (financial liability) — ₹ 5,00,000/(1.05)³. ₹ 68,000, the difference between the loan proceeds received ₹ 5,00,000 (the loan's face value) and present value of the loan ₹ 4,32,000, is a government grant and is recognised immediately as there are no specified future performance conditions.

The amount recognised on day one will accrete to ₹ 5,00,000 over the three-year term using the effective interest method.

Journal Entries**On Initial recognition:**

	₹	₹
Cash/Bank (financial asset) Dr.	5,00,000	
To Loan (financial liability)		4,32,000
To Income (profit or loss)		68,000
<i>(Being interest-free loan recognised at fair value and the receipt of a government grant)</i>		

At the end of

Year 1:

	₹	₹
Finance cost (profit or loss) Dr.	21,600	
To Loan (financial liability)		21,600
<i>(Being accretion of time value recognised on the financial liability)</i>		

Year 2

	₹	₹
Finance cost (profit or loss) Dr.	22,680	
To Loan (financial liability)		22,680
<i>(Being accretion of time value recognised on the financial liability)</i>		

Year 3

	₹	₹
Finance cost (profit or loss) Dr.	23,720	
To Loan (financial liability)		23,720
<i>(Being accretion of time value recognised on the financial liability)</i>		

Immediately after all the accretions are recognised, the carrying amount of the loan is equal to its face value of ₹ 5,00,000, which is also the amount payable to the government.

	₹	₹
Loan (financial liability) Dr.	5,00,000	
To Cash/Bank		5,00,000
<i>(Being loan repaid to the government)</i>		

Working Note:

Calculation of Amortised Cost

Year	Opening balance (A)	Interest at 5% (B) = (A) × 5%	Cash flow (C)	Closing balance (A) + (B) – (C)
1	4,32,000	21,600	–	4,53,600
2	4,53,600	22,680	–	4,76,280
3	4,76,280	23,720*	(5,00,000)	–

* Difference is due to approximation.

IND AS 21 – THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

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\$. Determine the functional currency of Future Ltd.?

Solution

The functional currency of Future Ltd. is the 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.

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. Determine the functional currency of Small India Private Limited?

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 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.

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

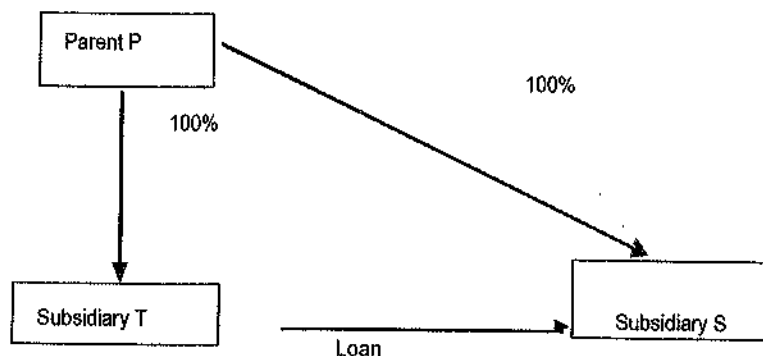
The exchange gain or loss will arise in the books of accounts of P in respect of its trading balance with S and the same should be recognised in profit or loss. This being a balance for in the nature of trade receivable for P, it would not be considered as its net investment in a foreign operation (i.e. 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.

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 i.e., on the directions of P, T gives the loan to S. T is also a subsidiary of P. Where should the exchange differences 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.

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 differences be accounted for in the consolidated financial statements?

(Being foreign exchange difference recorded at year end)		

Accounting treatment in the books of G Ltd (Functional currency EURO)

G Ltd will recognize purchases on 1st February, 20X1 of Euro 12 lacs which will also be its closing stock at year end.

Journal Entry.

	(in Euros)	(in Euros)
Purchases Dr.	12 lakhs	
To M Ltd.		12 lakhs

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 recorded at lower of cost or NRV.

	Euro (in lacs)	Rate	₹ (In lacs)
Cost	12	83	996
NRV (Assumed Same)	12	85	1020

Therefore, no write off is required.

The amount of closing stock of ₹996 Lakhs includes two components–

- Cost of inventory for ₹ 830 lacs; and
- Profit element of ₹ 166 lacs; and

At the time of consolidation, the second elements amounting to ₹ 166 lacs will be eliminated from the closing stock.

Journal Entry

	₹ (in Lacs)	₹ (in Lacs)
Consolidated P&L A/c Dr.	166	
To Inventory		166
(Being profit element of intragroup transaction eliminated)		

Illustration 9

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.

Solution

P's gain on disposal would be calculated in the following manner:

	(₹ in Lakhs)
Sale proceeds	1500

Net assets of S	(1000)
NCI derecognised	100
Foreign currency translation reserve	180
Gain on disposal	780

Illustration 10

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?

Solution:

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.

Illustration 11

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:

	<u>USD</u>	<u>L\$</u>
Property, plant and equipment	50,000	
Receivables	<u>9,35,000</u>	
Total assets	<u>9,85,000</u>	
Issued capital	50,000	30,055
Opening retained earnings	28,000	15,274
Profit for the year	20,000	

Accounts payable	8,40,000
Accrued liabilities	<u>47,000</u>
Total equity and liabilities	<u>9,85,000</u>

Required:

Translate the statement of financial position 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

Solution

Translation of the financial statements			
	USD	Rate	L\$
Property, plant and equipment	50,000	1.13	44,248
Receivables	9,35,000	1.13	8,27,434
Total assets	<u>9,85,000</u>		<u>8,71,682</u>
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			24,376
Translation Reserve (proof below)			
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

Illustration 12 (Past Exam Dec'21, MTP Nov'23)

On 30th January, 20X1, A Ltd. purchased a machinery for \$ 5,000 from USA supplier on credit basis. A Ltd.'s functional currency is Rupees. The exchange rate on the date of transaction is 1 \$ = ₹ 60. The fair value of the machinery determined on 31st March, 20X1 is \$ 5,500. The exchange rate on 31st March, 20X1 is 1\$ = ₹ 65. The payment to overseas supplier done on 31st March 20X2 and the exchange rate on 31st March 20X2 is 1\$ = ₹ 67. The fair value of the machinery remain unchanged for the year ended on 31st March 20X2. Prepare the Journal entries for the year ended on 31st March 20X1 and year 20X2 according to Ind AS 21. Tax rate is 30%. A Ltd. follows revaluation method in respect of Plant & Machinery (5 Marks)

Solution:

Journal Entries

Purchase of Machinery on credit basis on 30th January 20X1:

		₹	₹
Machinery A/c (5,000 x \$ 60) Dr.		3,00,000	
To Creditors - Machinery			3,00,000
(Initial transaction will be recorded at exchange rate on the date of transaction)			

Exchange difference arising on translating monetary item on 31st March 20X1:

		₹	₹
Profit & Loss A/c [(5,000 x \$ 65) – (5,000 x \$ 60)] Dr.		25,000	
To Creditors - Machinery			25,000
Machinery A/c Dr.		30,000	
To Revaluation Surplus (OCI)			30,000
[Being Machinery revalued to USD 5,500; (₹ 60 x (USD 5,500 - USD 5,000))]			
Machinery A/c Dr.		27,500	
To Revaluation Surplus (OCI)			27,500
(Being Machinery measured at the exchange 31-03-20X1 rate on [USD 5,500 x (₹ 65 - ₹ 60)])			
Revaluation Surplus (OCI) Dr.		17,250	
To Deferred Tax Liability			17,250
(DTL created @ of 30% of the total OCI amount)			

Exchange difference arising on translating monetary item and settlement of creditors on 31st March 20X2:

		₹	₹
Creditors – Machinery A/c (5,000 x \$65) Dr.		3,25,000	

Profit & loss A/c [(5,000 x (\$ 67 - \$ 65)) Dr.	10,000	
To Bank A/c		3,35,000
Machinery A/c [(5,500 x (\$ 67 - \$ 65)) Dr.	11,000	
To Revaluation Surplus (OCI) A/c		11,000
Revaluation Surplus (OCI) A/c Dr.	3,300	
To Deferred Tax Liability A/c (DTL created @ of 30% of the total OCI amount)		3,300

Note: DT might also arise on creditors but since ICAI has not calculated the same, we have also ignored in this solution.

Illustration 13 (RTP Nov'18)

On 1st January, 2018, P Ltd. purchased a machine for \$ 2 lakhs. The functional currency of P Ltd. is Rupees. At that date the exchange rate was \$1 = ₹ 68. P Ltd. is not required to pay for this purchase until 30th June, 2018. Rupees strengthened against the \$ in the three months following purchase and by 31st March, 2018 the exchange rate was \$1 = ₹ 65. CFO of P Ltd. feels that these exchange fluctuations wouldn't affect the financial statements because P Ltd. has an asset and a liability denominated in rupees, which was initially the same amount. He also feels that P Ltd. depreciates this machine over four years so the future year-end amounts won't be the same.

Examine the impact of this transaction on the financial statements of P Ltd. for the year ended 31st March, 2018 as per Ind AS.

Solution

As per Ind AS 21 'The Effects of Changes in Foreign Exchange Rates' the asset and liability would initially be recognised at the rate of exchange in force at the transaction date ie 1st January, 2018. Therefore, the amount initially recognised would be ₹ 1,36,00,000 (\$ 2,00,000 x ₹ 68).

The liability is a monetary item so it is retranslated using the rate of exchange in force at 31st March, 2018. This makes the closing liability of ₹ 1,30,00,000 (\$ 2,00,000 x ₹ 65).

The profit on re-translation of ₹ 6,00,000 (₹ 1,36,00,000 – ₹ 1,30,00,000) is recognised in the Statement of profit or loss.

The machine is a non-monetary asset carried at historical cost. Therefore, it continues to be translated using the rate of ₹ 68 to \$ 1.

Depreciation of ₹ 8,50,000 (₹ 1,36,00,000 x $\frac{1}{4}$ x $\frac{3}{12}$) would be charged to profit or loss for the year ended 31st March, 2018.

The closing balance in property, plant and equipment would be ₹ 1,27,50,000 (₹ 1,36,00,000 – ₹ 8,50,000). This would be shown as a non-current asset in the Balance Sheet.

Illustration 14 – (RTP May'19) (MTP May'23)

Supplier, A Ltd., enters into a contract with a customer, B Ltd., on 1st January, 2018 to deliver goods in exchange for total consideration of USD 50 million and receives an upfront payment of USD 20 million on this date. The functional currency of the supplier is INR. The goods are delivered and revenue is recognised on 31st March, 2018. USD 30 million is received on 1st April, 2018 in full and final settlement of the purchase consideration.

State the date of transaction for advance consideration and recognition of revenue. Also state the amount of revenue in INR to be recognized on the date of recognition of revenue. The exchange rates on 1st January, 2018 and 31st March, 2018 are ₹ 72 per USD and ₹ 75 per USD respectively. (5 Marks)

Solution:

This is the case of Revenue recognised at a single point in time with multiple payments. As per the guidance given in Appendix B to Ind AS 21:

A Ltd. will recognise a non-monetary contract liability amounting ₹1,440 million, by translating USD 20 million at the exchange rate on 1st January, 2018 i.e. ₹ 72 per USD.

A Ltd. will recognise revenue at 31st March, 2018 (that is, the date on which it transfers the goods to the customer).

A Ltd. determines that the date of the transaction for the revenue relating to the advance consideration of USD 20 million is 1st January, 2018. Applying paragraph 22 of Ind AS 21, A Ltd. determines that the date of the transaction for the remainder of the revenue as 31st March, 2018.

On 31st March, 2018, A Ltd. will:

- De-recognise the non-monetary contract liability of USD 20 million and recognise USD 20 million of revenue using the exchange rate as at 1st January, 2018 i.e. ₹ 72 per USD; and
- Recognise revenue and a receivable for the remaining USD 30 million, using the exchange rate on 31st March, 2018 i.e. ₹ 75 per USD.
- The receivable of USD 30 million is a monetary item, so it should be translated using the closing rate until the receivable is settled.

Illustration 15 - (RTP - Nov 2019, May 2021), Past Exam – May 2022)

Global Limited, an Indian company acquired on 30th September, 20X1 70% of the share capital of Mark Limited, an entity registered as company in Germany. The functional currency of Global Limited is Rupees and its financial year end is 31st March, 20X2.

- (i) The fair value of the net assets of Mark Limited was 23 million EURO and the purchase consideration paid is 17.5 million EURO on 30th September, 20X1. The exchange rates as at 30th September, 20X1 was ₹ 82 / EURO and at 31st March, 20X2 was ₹ 84 / EURO.

What is the value at which the goodwill has to be recognised in the financial statements of Global Limited as on 31st March, 20X2?

- (ii) Mark Limited sold goods costing 2.4 million EURO to Global Limited for 4.2 million EURO during the year ended 31st March, 20X2. The exchange rate on the date of purchase by Global Limited was ₹ 83 / EURO and on 31st March, 20X2 was ₹ 84 / EURO. The entire goods purchased from Mark Limited are unsold as on 31st March, 20X2. Determine the unrealised profit to be eliminated in the preparation of consolidated financial statements. (6 Marks)

Solution

- i) Para 47 of Ind AS 21 requires that goodwill arose on business combination shall be expressed in the functional currency of the foreign operation and shall be translated at the closing rate in accordance with paragraphs 39 and 42. In this case the amount of goodwill will be as follows:

Net identifiable asset Dr. 23 million

Goodwill(bal. fig.) Dr. 1.4 million

To Bank 17.5 million

To NCI (23 x 30%) 6.9 million

Thus, goodwill on reporting date would be 1.4 million EURO x ₹ 84 = ₹117.6 million

ii)

Particulars	EURO in million
Sale price of Inventory	4.20

Unrealised Profit [a]

1.80

Exchange rate as on date of purchase of Inventory [b] ₹ 83 / Euro Unrealized profit to be eliminated [a x b] ₹ 149.40 million

As per para 39 of Ind AS 21 "income and expenses for each statement of profit and loss presented (ie including comparatives) shall be translated at exchange rates at the dates of the transactions".

In the given case, purchase of inventory is an expense item shown in the statement profit and loss account. Hence, the exchange rate on the date of purchase of inventory is taken for calculation of unrealized profit which is to be eliminated on the event of consolidation.

Illustration 16 – (RTP – May 2020)

On 1st April, 20X1, Makers Ltd. raised a long term loan from foreign investors. The investors subscribed for 6 million Foreign Currency (FCY) loan notes at par. It incurred incremental issue costs of FCY 2,00,000. Interest of FCY 6,00,000 is payable annually on 31st March, starting from 31st March, 20X2. The loan is repayable in FCY on 31st March, 20X7 at a premium and the effective annual interest rate implicit in the loan is 12%. The appropriate measurement basis for this loan is amortised cost. Relevant exchange rates are as follows:

- 1st April, 20X1 - FCY 1 = ₹ 2.50.
- 31st March, 20X2 - FCY 1 = ₹ 2.75.
- Average rate for the year ended 31st March, 20X2 - FCY 1 = ₹ 2.42. The functional currency of the group is Indian Rupee.

Advise the appropriate accounting treatment for the foreign currency loan in the books of Makers Ltd. for the FY 20X1-20X2? Calculate the initial measurement amount for the loan, finance cost for the year, closing balance and exchange gain / loss.

Solution

Initial carrying amount of loan in books	Loan amount received	= 60,00,000 FCY
Less: Incremental issue costs		= 2,00,000 FCY
		58,00,000 FCY

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

Loan to be converted in INR = 58,00,000 FCY x ₹ 2.50/FCY = ₹ 1,45,00,000

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

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

Period	Opening Financial Liability (FCY) A	Interest @ 12% (FCY) B	Cash Flow (FCY) C	Closing Financial Liability (FCY) A+B-C
20X1-20X2	58,00,000	6,96,000	6,00,000	58,96,000

The finance cost in FCY is 6,96,000

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

Hence, the finance cost for FY 20X1-20X2 in INR is ₹ 16,84,320 (6,96,000 FCY x ₹ 2.42 / FCY)

The actual payment of interest would be recorded at 6,00,000 x 2.75 = INR 16,50,000

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

So the closing loan balance in INR is 58,96,000 FCY x INR 2.75 / FCY = ₹ 1,62,14,000

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

This exchange difference is taken to profit and loss.

Question 1 - (MTP OCT'18)

ABC Ltd. works out translation gain/loss over the years on its investment in foreign subsidiary 2014-15: Rs. 2 lakhs, 2015-16: Rs. 4 lakhs, 2016-17: Rs. 3 lakhs. The foreign subsidiary is sold on 30th June 2017. The translation gain on sale of such investment as on that date is Rs. 2 lakhs. Assuming that deferred tax effect is computed @ 30%. How should the company present the translation gain/loss, deferred taxation and reclassification adjustment in the Profit and loss, other comprehensive income, equity and liabilities?

SOLUTION:

	Statement of Profit and loss		Equity Liabilities	
	Profit and loss	Other-comprehensive income	Equity	Liabilities
2014-15				
Translation Gain		2.00		
Less: Deferred Tax Expenses		(0.60)		
Translation Reserve		<u>1.40</u>	1.40	
Deferred tax liabilities				0.60
2015-16				
Translation Gain		2.00		
Less: Deferred Tax Expenses		(0.60)		
Translation Reserve		<u>1.40</u>	2.80	
Deferred tax liabilities				1.20
2016-17				
Translation loss		(1.00)		
Less: Deferred Tax Expenses		0.30		
Translation Reserve		<u>(0.70)</u>	2.10	
Deferred tax liabilities				0.90
2017-18				
Translation loss		(1.00)		
Less: Deferred Tax Expenses		0.30		
Translation Reserve		<u>(0.70)</u>	1.40	
Deferred tax liabilities				0.60
Reclassification adjustment credited to P&L	1.40			
Current Tax				(0.60)
Adjustment of deferred tax liabilities	0.60			

Question 2 - (RTP May'19)

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?

Solution

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.

Question 3 - (PAST EXAM Nov'19) + (MTP March'21)

What is the functional currency of an entity? What are the primary and secondary factors that influence determination of functional currency? (4 Marks)

Solution:

- (a) 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.

The following are the factors that influence determination of an appropriate functional currency

1. Primary Indicators:

(a) the currency:

- 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
- of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.
- 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.

2. Secondary indicators: Other factors that may provide supporting evidence to determine an entity's functional currency are-

- the currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated; and
- the currency in which receipts from operating activities are usually retained.

Question 4 – (MTP Nov'21)

PQR Holdings Limited is based in London and has Pound sterling ("GBP") as its functional and presentation currency. On 1st April, 20X1, PQR Holdings Limited incorporated PQR India Limited as its wholly owned subsidiary in India. PQR India will be engaged in trading of items purchased from PQR Holdings. The shares of PQR India, having a face value of ₹ 10 each amounting to total of ₹ 500 crore, were issued to PQR Holdings in GBP on 1st April, 20X1.

PQR India has adopted Ind AS with effect from its incorporation. In accordance with Ind AS, management of PQR India has concluded that its functional currency is Indian Rupee ("INR"). Following is the summarized trial balance of PQR India as on 31st March, 20X2, being the reporting date of PQR India and PQR Holdings:

(Note: All amounts in the below mentioned trial balance are ₹ in crore)

S. No.	Particulars	Debit Balances	Credit Balances
1.	Share capital	-	500.0
2.	Securities premium reserve on issue of equity shares	-	150.0
3.	Retained earnings	-	110.0
4.	Long-term borrowings	-	30.0
5.	Deferred tax liability	-	10.0
6.	Income tax payable	-	25.0
7.	Import duty payable	-	5.0
8.	Employee benefits payable	-	7.5
9.	Sundry trade payables	-	2.5
10.	Property, plant and equipment (net of depreciation)	550.0	-
11.	Computer software (net of amortisation)	70.0	-
12.	Inventories purchased on 15 th March, 20X2 (there is no indicator of impairment)	200.0	-
13.	Cash and bank balance	5.0	-
14.	Sundry trade receivables	17.0	-
15.	Allowance for doubtful trade receivables	-	2.0
	Total	842.0	842.0

Additional information relating to property, plant and equipment, and computer software:

Line item	Date of acquisition
Property, plant and equipment	30 th April, 20X1
Computer software	5 th May, 20X1

PQR India has adopted the following accounting policy in relation to shareholders' funds to translate equity:

Share capital	To be translated using historical exchange rate
Securities premium	To be translated using historical exchange rate
Retained earnings	To be translated using average exchange rate

Since the presentation currency of PQR Holdings is GBP, PQR India is required to translate its trial balance from INR to GBP. Following table provides relevant foreign exchange rates:

Closing spot rate as on 1 st April, 20X1	1 INR = 0.0123 GBP
Closing spot rate as on 30 th April, 20X1	1 INR = 0.0120 GBP
Closing spot rate as on 5 th May, 20X1	1 INR = 0.0119 GBP
Closing spot rate on 15 th March, 20X2	1 INR = 0.0108 GBP
Closing spot rate as on 31 st March, 20X2	1 INR = 0.0109 GBP
Average exchange rate for the year ended 31 st March, 20X2	1 INR = 0.0116 GBP

As the accountant of PQR India, you are required to do the following for its separate financial statements:

- a) Explain the principle of monetary and non-monetary items. Based on this principle, bifurcate the line items of the trial balance into monetary and non-monetary items.
- b) Translate the trial balance of PQR India from INR to GBP. (14 Marks)

Solution:

- a) Monetary items are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency. Para 15 of Ind AS 21 states that the essential feature of a monetary item is a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Similarly, a 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 is a monetary item.

Conversely, the essential feature of a non-monetary item is the absence of a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency.

On the basis of above principles, the line items of trial balance should be bifurcated as follows:

Particulars	Monetary item / Non-monetary item
Share Capital	Non-monetary item
Securities Premium reserve on issue of equity shares	Non-monetary item
Retained earnings	Non-monetary item
Long-term borrowings	Monetary item
Deferred tax liability	Non-monetary item
Income tax payable	Monetary item
Import duty payable	Monetary item
Employee benefits payable	Monetary item
Sundry trade payables	Monetary item
Property, plant and equipment (net of depreciation)	Non-monetary item
Computer software (net of amortization)	Non-monetary item
Inventories purchased (there is no indicator of impairment)	Non-monetary item
Cash and bank balance	Monetary item
Sundry trade receivables	Monetary item
Allowance for doubtful trade receivables	Monetary item

As per para 38 of Ind AS 21, an entity may present its financial statements in any currency (or currencies). If the presentation currency differs from the entity's functional currency, it translates its results and financial position into the presentation currency. For example, when a group contains individual entities with different functional currencies, the results and financial position of each entity are expressed in a common currency so that consolidated financial statements may be presented.

- (b) Translation of the balances for the purpose of consolidation

Particulars	INR incrore	Rate(GBP)	Amount in GBP
Property, plant and equipment (net of depreciation)	550.0	0.0109	5.995
Computer software (net of amortization)	70.0	0.0109	0.763
Inventories	200.0	0.0109	2.18
Cash and bank balance	5.0	0.0109	0.0545

Sundry trade receivables net of allowance for doubtful trade receivables (17.0-2.0)	<u>15.0</u>	0.0109	<u>0.1635</u>
Total Assets	<u>840.0</u>		<u>9.156</u>
Share Capital	500.0	0.0123	6.15
Securities Premium reserve	150.0	0.0123	1.845
Retained earnings	110.0	0.0116	1.276
Long-term borrowings	30.0	0.0109	0.327
Deferred tax liability	10.0	0.0109	0.109
Income tax payable	25.0	0.0109	0.2725
Import duty payable	5.0	0.0109	0.0545
Employee benefits payable	7.5	0.0109	0.08175
Sundry trade payables	2.5	0.0109	0.02725
Foreign Currency Translation reserve recognised in OCI (balancing figure)			<u>(0.987)</u>
Total Equity and liabilities	<u>840.0</u>		<u>9.156</u>

Question 5 (RTP Nov'23)

Infotech Global Ltd. (a stand-alone entity) has a functional currency of USD and needs to translate its financial statements into the presentation currency (INR). The following is the draft financial statements of Infotech Global Ltd. prepared in accordance with its functional currency.

Balance Sheet

Particulars	31st March, 20X3	31st March, 20X2
	USD	USD
Property, plant and equipment	50,000	55,000
Trade Receivables	68,500	56,000
Inventory	8,000	5,000
Cash	<u>40,000</u>	<u>35,000</u>
Total assets	<u>1,66,500</u>	<u>1,51,000</u>
Share Capital	50,000	50,000
Retained earnings	29,500	18,000
Total Equity	<u>79,500</u>	<u>68,000</u>
Trade payables	40,000	38,000
Loan	<u>47,000</u>	<u>45,000</u>
Total liabilities	<u>87,000</u>	<u>83,000</u>
Total equity and liabilities	<u>1,66,500</u>	<u>1,51,000</u>

Statement of Profit and Loss

Particulars	USD
Revenue	1,77,214
Cost of sales	<u>1,13,100</u>

Gross Profit	64,114
Distribution costs	2,400
Administrative expenses	18,000
Other expenses	11,000
Finance costs	<u>12,000</u>
Profit before tax	20,714
Income tax expense	<u>6,214</u>
Profit for the year	14,500

Extracts from Statement of Changes in Equity

Particulars	31st March, 20X3 (USD)
Retained earnings at the beginning of the year	18,000
Profit for the year	14,500
Dividends	<u>(3,000)</u>
Retained earnings at the end of the year	<u>29,500</u>

- Share capital was issued when the exchange rate was USD 1 = INR 70.
- Retained earnings on 1st April, 20X1 was INR 4,00,000.
- At 31st March, 20X2, a cumulative gain of INR 4,92,000 has been recognised in the foreign exchange reserve, which is due to translation of entity's financial statements into INR in the previous years.
- Entity paid a dividend of USD 3,000 when the rate of exchange was USD 1 = INR 73.5
- Profit for the year 20X1-20X2 of USD 8,000, translated in INR at INR 5,72,000.
- Profit for the year 20X2-20X3 of USD 14,500, translated in INR at INR 10,72,985.

For the sake of simplicity, items of income and expense are translated at weighted average monthly rate as there has been no significant exchange rate fluctuation during the entire year and the business of the entity is not cyclical in nature.

Relevant exchange rates are as follows:

- Rate at 31st March, 20X2 USD 1= INR 73
- Rate at 31st March, 20X3 USD 1= INR 75

Prepare financial statements of Infotech Global Ltd. translated from functional currency (USD) to presentation currency (INR).

Solution:

As per paragraph 39 of Ind AS 21, all assets and liabilities are translated at the closing exchange rate, which is USD 1 = INR 73 on 31st March, 20X2 and USD 1 = INR 75 on 31st March, 20X3.

In the given case, share capital is translated at the historical rate USD 1 = INR 70. The share capital will not be restated at each year end. It will remain unchanged.

Accordingly, the translated financial statements will be as follows:

Note 1: Retained earnings at 31st March, 20X3 and 31st March, 20X2:

Particulars	31st March, 20X3	31st March, 20X2
	INR	INR
Opening retained earnings	9,72,000	4,00,000

Profit for the year	10,72,985	5,72,000
Dividends paid (USD 3,000 x INR 73.5)	<u>(2,20,500)</u>	-
Closing retained earnings	<u>18,24,485.9</u>	<u>72,000</u>

Balance Sheet

Particulars	31st March, 20X3			31st March, 20X2		
	USD	Rate	INR	USD	Rate	INR
Property, plant and equipment	50,000	75	37,50,000	55,000	73	40,15,000
Trade Receivables	68,500	75	51,37,500	56,000	73	40,88,000
Inventory	8,000	75	6,00,000	5,000	73	3,65,000
Cash	40,000	75	30,00,000	35,000	73	25,55,000
Total assets	1,66,500		1,24,87,500	1,51,000		1,10,23,000
Share Capital	50,000	70	35,00,000	50,000	70	35,00,000
Retained earnings (Refer note 1)	29,500		18,24,485	18,000		9,72,000
Foreign Exchange reserve (Bal Fig.)			<u>6,38,015</u>	-		<u>4,92,000</u>
Total Equity	79,500		59,62,500	68,000		49,64,000
Trade payables 4	0,000	75	30,00,000	38,000	73	27,74,000
Loan	<u>47,000</u>	<u>75</u>	<u>35,25,000</u>	<u>45,000</u>	<u>73</u>	<u>32,85,000</u>
Total liabilities	<u>87,000</u>		<u>65,25,000</u>	<u>83,000</u>		<u>60,59,000</u>
Total equity and liabilities	<u>1,66,500</u>		<u>1,24,87,500</u>	<u>1,51,000</u>		<u>1,10,23,000</u>

The foreign exchange reserve is the exchange difference resulting from translating income and expense at the average exchange rate and assets and liabilities at the closing rate.

Other Comprehensive Income

Exchange differences on translating from USD to INR (6,38,015 - 4,92,000)	INR 1,46,015

Statement of Changes in Equity (INR)

Particulars	Share Capital	Retained Earnings	Foreign exchange Reserve	Total
Balance at 1st April, 20X2	35,00,000	9,72,000	4,92,000	49,64,000
Dividends	-	(2,20,500)	-	(2,20,500)
Profit for the year	-	10,72,985	-	10,72,985
Exchange difference (transferred to OCI)	-	-	1,46,015	1,46,015
Balance at 31st March, 20X3	<u>35,00,000</u>	<u>18,24,485</u>	<u>6,38,015</u>	<u>59,62,500</u>

IND AS 23 – BORROWING COSTS

Illustration 1

A company deals in production of dairy products. It prepares and sells various milk products like ghee, butter and cheese. The company borrowed funds from bank for manufacturing operation. The cheese takes substantial longer period to get ready for sale.

State whether borrowing costs incurred to finance the production of inventories (cheese) that have a long production period, be capitalised?

Solution:

Ind AS 23 does not require the capitalisation of borrowing costs for inventories that are manufactured in large quantities on a repetitive basis. However, interest capitalisation is permitted as long as the production cycle takes a 'substantial period of time', as with cheese.

Illustration 2

A company is in the process of developing computer software. The asset has been qualified for recognition purposes. However, the development of computer software will take substantial period of time to complete.

- (i) Can computer software be termed as a 'qualifying asset' under Ind AS 23?
- (ii) Is management intention considered when assessing whether an asset is a qualifying asset?

Solution:

- i) Yes. An intangible asset that takes a substantial period of time to get ready for its intended use or sale is a 'qualifying asset'. This would be the case for an internally generated computer software in the development phase when it takes a 'substantial period of time' to complete.
- ii) Yes. Management should assess whether an asset, at the date of acquisition, is 'ready for its intended use or sale'. The asset might be a qualifying asset, depending on how management intends to use it. For example, when an acquired asset can only be used in combination with a larger group of fixed assets or was acquired specifically for the construction of one specific qualifying asset, the assessment of whether the acquired asset is a qualifying asset is made on a combined basis.

Illustration 3

A telecom company has acquired a 3G license. The licence could be sold or licensed to a third party. However, management intends to use it to operate a wireless network. Development of the network starts when the license is acquired.

Should borrowing costs on the acquisition of the 3G license be capitalised until the network is ready for its intended use?

Solution:

Yes. The license has been exclusively acquired to operate the wireless network. The fact that the license can be used or licensed to a third party is irrelevant. The acquisition of the license is the first step in a wider investment project (developing the network). It is part of the network investment, which meets the definition of a qualifying asset under Ind AS 23.

Illustration 4

A real estate company has incurred expenses for the acquisition of a permit allowing the construction of a building. It has also acquired equipment that will be used for the construction of various buildings.

Can borrowing costs on the acquisition of the permit and the equipment be capitalised until the construction of the building is complete?

Solution:

With respect to Permit

Yes, since permit is specific to one building. It is the first step in a wider investment project. It is part of the construction cost of the building, which meets the definition of a qualifying asset.

With respect to Equipment

No, since the equipment will be used for other construction projects. It is ready for its 'intended use' at the acquisition date. Hence, it does not meet the definition of a qualifying asset.

Illustration 5 (MTP April'22)

ABC Ltd. has taken a loan of USD 20,000 on April 1, 20X1 for constructing a plant at an interest rate of 5% per annum payable on annual basis.

On April 1, 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. March 31, 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 April 1, 20X1.

Compute the borrowing cost to be capitalized for the construction of plant by ABC Ltd for the period ending 31st March, 20X2. **(6 Marks)**

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 : $\text{USD } 20,000 \times 5\% = \text{USD } 1,000$

Converted in ₹ : $\text{USD } 1,000 \times ₹ 48/\text{USD} = ₹ 48,000$

Increase in liability due to change in exchange difference : $\text{USD } 20,000 \times (48 - 45) = ₹ 60,000$

- b) Interest that would have resulted if the loan was taken in Indian Currency:

$\text{USD } 20,000 \times ₹ 45/\text{USD} \times 11\% = ₹ 99,000$

- 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
		<u>₹ 99,000</u>

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.

Illustration 6

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
1 st April, 20X1	5,00,000	10,00,000
1 st 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) <u>(17,500)</u>	(10,00,000 x 7% x 6/12) <u>(35,000)</u>
	<u>72,500</u>	<u>1,45,000</u>
Cost of the asset:		
Expenditure incurred	10,00,000	20,00,000
Borrowing Costs	<u>72,500</u>	<u>1,45,000</u>
Total	<u>10,72,500</u>	<u>21,45,000</u>

Illustration 7

On 1st April, 20X1, A Ltd. took a 8% loan of ₹ 50,00,000 for construction of building A which is repayable after 6 years i.e. on 31st March 20X7. The construction of building was completed on 31st March 20X3. A Ltd. started constructing a new building B in the year 20X3-20X4, for which he used his existing borrowings. He has outstanding general purpose loan of ₹ 25,00,000, interest on which is payable @ 9% and ₹ 15,00,000, interest on which is payable @ 7%.

Recommend whether the specific borrowing transferred to the general borrowings pool once the respective qualifying asset is completed?

Solution:

Yes. If specific borrowings were not repaid once the relevant qualifying asset was completed, they become general borrowings for as long as they are outstanding.

The borrowing costs that are directly attributable to obtaining qualifying assets are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. If cash was not spent on other qualifying assets, it could be directed to repay this specific loan. Thus, borrowing costs could be avoided (that is, they are directly attributable to other qualifying assets).

Illustration 8

Beta Ltd had the following loans in place at the end of 31st March, 20X2:

(Amounts in ₹000s)

Loan	1 st April, 20X1	31 st 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: Rs 500,000 on 1st April, 20X1 and Rs 2,500,000 on 1st January, 20X2.

Calculate the borrowing cost that can be capitalised for the plant.

Solution

Capitalisation rate	$\frac{(18\% \times 1,000) + (16\% \times 3,000)}{1,000 + 3,000}$	16.5%
Borrowing Costs	$(500,000 \times 16.5\%) + (2,500,000 \times 16.5\% \times 3/12)$	₹1,85,625

Capitalisation rate for above illustration could also be calculated with the following approach by assigning weights to the borrowings:

Particulars	Loan	Weighted average (a)	Interest rate (b)	Capitalisation rate (a*b)
18% Bank Loan	1,000	25%	18%	4.5%
16% Term Loan	3,000	75%	16%	12%
Total	4,000	100%		16.5%

Answer in both the approaches would be same as can be seen from the above two solutions.

Illustration 9

X Ltd is commencing a new construction project, which is to be financed by borrowing. The key dates are as follows:

- 15th May, 20X1: Loan interest relating to the project starts to be incurred
- 2nd June, 20X1 : Technical site planning commences
- 19th June, 20X1 : Expenditure on the project started to be incurred
- 18th July, 20X1 : Construction work commences

Identify the commencement date for capitalisation of borrowing cost.

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.

Illustration 10

Marine Transport Limited ordered 3 ships for its fleet on April 1, 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 March 1, 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.

Advise whether it is permissible for Marine Transport Limited to capitalise any borrowing costs for the financial year ended March 31, 20X1 or March 31, 20X2.

Solution

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:

- It incurs expenditures for the asset.
- It incurs borrowing costs.
- 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 April 1, 20X0. Thus condition (a) and (b) are met. However, condition (c) is met only on March 1, 20X2, and that too only with respect to one ship. Thus, there is no capitalisation of borrowing costs during the financial year ended March 31, 20X1. Even during the financial year ended March 31, 20X2, borrowing costs relating to the 'one' ship whose construction had commenced from March 1, 20X2 will be capitalised from March 1, 20X2 to March 31, 20X2.

All other borrowing costs are expensed.

Illustration 11

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 March 31, 20X2, the Company commenced the construction of a qualifying asset and incurred the following expenses:

Date	Amount (₹)
July 1, 20X1	2,50,000
December 1, 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.

Solution

The capitalisation rate is:

Total borrowing costs / Weighted average total borrowings: $1,65,000 / 15,00,000 = 11\%$

Interest to be capitalised is calculated 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

Total interest capitalised for year ended 31 March 2002 is ₹ 31,625

Illustration 12 - (RTP May'18) (Past Exam Nov'19)

An entity constructs a new head office building commencing on 1st September 20X1, which continues till 31st December 20X1. Directly attributable expenditure at the beginning of the month on this asset are ₹100,000 in September 20X1 and ₹250,000 in each of the months of October to December 20X1.

The entity has not taken any specific borrowings to finance the construction of the asset, but has incurred finance costs on its general borrowings during the construction period. During the year, the entity had issued 10% debentures with a face value of ₹ 20 lacs and had an overdraft of ₹ 500,000, which increased to ₹ 750,000 in December 20X1. Interest was paid on the overdraft at 15% until 1 October 20X1, then the rate was increased to 16%.

Calculate the capitalization rate for computation of borrowing cost in accordance with Ind AS 23 'Borrowing Costs'.

Solution

Since the entity has only general borrowing hence first step will be to compute the capitalisation rate. The capitalisation rate of the general borrowings of the entity during the period of construction is calculated as follows:

Finance cost on ₹ 20 lacs 10% debentures during September – December 20X1	₹ 66,667
Interest @ 15% on overdraft of ₹ 5,00,000 in September 20X1	₹ 6,250
Interest @ 16% on overdraft of ₹ 5,00,000 in October and November 20X1	₹ 13,333
Interest @ 16% on overdraft of ₹ 750,000 in December 20X1	₹ 10,000
Total finance costs in September – December 20X1	₹ 96,250

Weighted average borrowings during period = $\frac{(20,00,000 \times 4) + (500,000 \times 3) + (750,000 \times 1)}{4} = ₹ 25,62,500$

4

Capitalisation rate = Total finance costs during the construction period / Weighted average borrowings during the construction period

= $96,250 / 25,62,500 = 3.756\%$ (This % is not p.a., it is for 4 months)

Illustration 13 - (RTP - Nov 2018)

K Ltd. began construction of a new building at an estimated cost of ₹ 7 lakh on 1st April, 2017. To finance construction of the building it obtained a specific loan of ₹ 2 lakh from a financial institution at an interest rate of 9% per annum.

The company's other outstanding loans were:

Amount	Rate of Interest per annum
₹ 7,00,000	12%
₹ 9,00,000	11%

The expenditure incurred on the construction was:

April, 2017	₹ 1,50,000
August, 2017	₹ 2,00,000
October, 2017	₹ 3,50,000
January, 2018	₹ 1,00,000

The construction of building was completed by 31st January, 2018. Following the provisions of Ind AS 23 'Borrowing Costs', calculate the amount of interest to be capitalized and pass necessary journal entry for capitalizing the cost and borrowing cost in respect of the building as on 31st January, 2018.

Solution**(i) Calculation of capitalization rate on borrowings other than specific borrowings**

Amount of loan (₹)	Rate of interest	Amount of interest (₹)
7,00,000	12%	= 84,000
9,00,000	11%	= <u>99,000</u>
16,00,000		<u>1,83,000</u>
Weighted average rate of interest (1,83,000/16,00,000) x 100		= 11.4375%

(ii) Computation of borrowing cost to be capitalized for specific borrowings and general borrowings based on weighted average accumulated expenses

Date of incurrence of expenditure	Amount spent	Financed through	Calculation	₹
1st April, 2017	1,50,000	Specific borrowing	1,50,000 x 9% x 10/12	11,250
1st August, 2017	2,00,000	Specific borrowing	50,000 x 9% x 10/12	3,750
		General borrowing	1,50,000 x 11.4375% x 6/12	8,578.125
1st October, 2017	3,50,000	General borrowing	3,50,000 x 11.4375% x 4/12	13,343.75
1st January, 2018	1,00,000	General borrowing	1,00,000 x 11.4375% x 1/12	<u>953.125</u>
				<u>37,875</u>

Note: Since construction of building started on 1st April, 2017, it is presumed that all the later expenditures on construction of building had been incurred at the beginning of the respective month.

(iii) Total expenses to be capitalized for building

	₹
Cost of building ₹ (1,50,000 + 2,00,000 + 3,50,000 + 1,00,000)	8,00,000
Add: Amount of interest to be capitalized	<u>37,875</u>
	<u>8,37,875</u>

(iv)**Journal Entry**

Date	Particulars		₹	₹
31.1.2018	Building account	Dr.	8,37,875	
	To Bank account			8,00,000
	To Interest payable (borrowing cost)			37,875
	(Being expenditure incurred on construction of building and borrowing cost thereon capitalized)			

Note: In the above journal entry, it is assumed that interest amount will be paid at the year end. Hence, entry for interest payable has been passed on 31.1.2018.

Alternatively, following journal entry may be passed if interest is paid on the date of capitalization:

Date	Particulars		₹	₹
31.1.2018	Building account	Dr.	8,37,875	
	To Bank account			8,37,875
	(Being expenditure incurred on construction of building and borrowing cost thereon capitalized)			

Illustration 14 - (RTP Nov'19) (MTP Oct'20)

On 1st April, 20X1, entity A contracted for the construction of a building for ₹ 22,00,000. The land under the building is regarded as a separate asset and is not part of the qualifying assets. The building was completed at the end of March, 20X2, and during the period the following payments were made to the contractor

Payment date	Amount (₹ '000)
1st April, 20X1	200
30th June, 20X1	600
31st December, 20X1	1,200
31st March, 20X2	200
Total	2,200

Entity A's borrowings at its year end of 31st March, 20X2 were as follows:

- 10%, 4-year note with simple interest payable annually, which relates specifically to the project; debt outstanding on 31st March, 20X2 amounted to ₹ 7,00,000. Interest of ₹ 65,000 was incurred on these borrowings during the year, and interest income of ₹ 20,000 was earned on these funds while they were held in anticipation of payments.
- 12.5%, 10-year note with simple interest payable annually; debt outstanding at 1st April, 20X1 amounted to ₹ 1,000,000 and remained unchanged during the year; and
- 10%, 10-year note with simple interest payable annually; debt outstanding at 1st April, 20X1 amounted to ₹ 1,500,000 and remained unchanged during the year.

What amount of the borrowing costs can be capitalized at year end as per relevant Ind AS?

(6 Marks)

Solution

As per Ind AS 23, 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 amount of borrowing costs eligible for capitalization, in cases where the funds are borrowed generally, should be determined based on the capitalisation rate and expenditure incurred in obtaining a qualifying asset. The costs incurred should first be allocated to the specific borrowings.

Analysis of expenditure:

Date	Expenditure (₹'000)	Amount allocated in general borrowings (₹'000)	Weighted for period outstanding (₹'000)
1st April 20X1	200	0	0
30th June 20X1	600	100*	$100 \times 9/12 = 75$
31st Dec 20X1	1,200	1,200	$1,200 \times 3/12 = 300$
31st March 20X2	200	200	$200 \times 0/12 = 0$
Total	2,200		375

Specific borrowings of ₹ 7,00,000 fully utilized on 1st April & on 30th June to the extent of ₹ 5,00,000 hence remaining expenditure of ₹ 1,00,000 allocated to general borrowings.

The expenditure rate relating to general borrowings should be the weighted average of the borrowing costs applicable to the entity's borrowings that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset.

Capitalisation rate = $(10,00,000 \times 12.5\%) + (15,00,000 \times 10\%) = 11\%$

$10,00,000 + 15,00,000$

Borrowing cost to be capitalized:	Amount (₹)
On specific loan	65,000
On General borrowing $(3,75,000 \times 11\%)$	41,250
Total	1,06,250
Less interest income on specific borrowings	(20,000)
Amount eligible for capitalization	86,250
Therefore, the borrowing costs to be capitalized are ₹ 86,250.	

Illustration 15

In a group with Parent Company "P" there are 3 subsidiaries with following business:

"A" – Real Estate Company

"B" – Construction Company

"C" – Finance Company

- Parent Company has no operating activities of its own but performs management functions for its subsidiaries.
- Financing activities and cash management in the group are coordinated centrally.
- Finance Company is a vehicle used by the group solely for raising finance.
- All entities in the group prepare Ind AS financial statements.

The following information is relevant for the current reporting period 20X1-20X2:

Real Estate Company

- Borrowings of ₹ 10,00,000 with an interest rate of 7% p.a.
- Expenditures on qualifying assets during the period amounted to ₹ 15,40,000.
- All construction works were performed by Construction Company. Amounts invoiced to Real Estate Company included 10% profit margin.

Construction Company

- No borrowings during the period.
- Financed ₹ 10,00,000 of expenditures on qualifying assets using its own cash resources.

Finance Company

- Raised ₹ 20,00,000 at 7% p.a. externally and issued a loan to Parent Company for general corporate purposes at the rate of 8%.

Parent Company

- Used loan from Finance Company to acquire a new subsidiary.
- No qualifying assets apart from those in Real Estate Company and Construction Company.
- Parent Company did not issue any loans to other entities during the period.

What is the amount of borrowing costs eligible for capitalisation in the financial statements of each of the four entities for the current reporting period 20X1-20X2?

Solution:

Following is the treatment as per Ind AS 23:

Finance Company

No expenditure on qualifying assets have been incurred, so Finance Company cannot capitalise anything.

Real Estate Company

Total interest costs in the financial statements of Real Estate Company is ₹ 70,000. Expenditures on qualifying assets exceed total borrowings, so the total amount of interest can be capitalised.

Construction Company

No interest expense has been incurred, so Construction Company cannot capitalise anything.

Consolidated financial statements of Parent Company:

Total general borrowings of the group: ₹ 10,00,000 + ₹ 20,00,000 = ₹ 30,00,000

Although Parent Company used proceeds from loan to acquire a subsidiary, this loan cannot be excluded from the pool of general borrowings.

Total interest expenditures for the group = ₹ 30,00,000 × 7% = ₹ 2,10,000

Total expenditures on qualifying assets for the group are added up. Profit margin charged by Construction Company to Real Estate Company is eliminated:

Real Estate Company – ₹ 15,40,000/1.1 = ₹ 14,00,000

Construction Co – ₹ 10,00,000

Total consolidated expenditures on qualifying assets: ₹ (14,00,000 + 10,00,000) = ₹ 24,00,000

Capitalisation rate = 7%

Borrowing costs eligible for capitalisation = ₹ 24,00,000 × 7% = ₹ 1,68,000

Total interest expenditures of the group are higher than borrowing costs eligible for capitalisation calculated based on the actual expenditures incurred on the qualifying assets. Therefore, only ₹ 1,68,000 can be capitalised.

Illustration 16 – (RTP – May 2021)

How will you capitalise the interest when qualifying assets are funded by borrowings in the nature of bonds that are issued at discount?

Y Ltd. issued at the start of year 1, 10% (interest paid annually and having maturity period of 4 years) bonds with a face value of ₹ 2,00,000 at a discount of 10% to finance a qualifying asset which is ready for intended use at the end of year 2.

Compute the amount of borrowing costs to be capitalized if the company amortizes discount using Effective Interest Rate method by applying 13.39% p.a. of EIR.

Solution**Capitalisation Method**

As per the Standard, borrowing costs may include interest expense calculated using the effective interest method. Further, capitalisation of borrowing cost should cease where substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

Thus, only that portion of the amortized discount should be capitalised as part of the cost of a qualifying asset which relates to the period during which acquisition, construction or production of the asset takes place.

Capitalisation of Interest

Hence based on the above explanation the amount of borrowing cost of year 1 & 2 are to be capitalised and the borrowing cost relating to year 3 & 4 should be expensed.

Quantum of Borrowing

The value of the bond to Y Ltd. is the transaction price i.e. ₹ 1,80,000 (2,00,000 – 20,000) Therefore, Y Ltd will recognize the borrowing at ₹ 1,80,000.

Computation of the amount of Borrowing Cost to be Capitalised

Y Ltd will capitalise the interest (borrowing cost) using the effective interest rate of 13.39% for two years as the qualifying asset is ready for intended use at the end of the year 2, the details of which are as follows:

Year	Opening Borrowing	Interest expense @ 13.39% to be capitalised	Total	Interest paid	Closing Borrowing
	(1)	(2)	(3)	(4)	(5) = (3) – (4)
1	1,80,000	24,102	2,04,102	20,000	1,84,102
2	1,84,102	24,651	2,08,753	20,000	1,88,753
		48,753			

Accordingly, borrowing cost of ₹ 48,753 will be capitalized to the cost of qualifying asset.

Illustration 17 – (RTP Dec'21) (Past Exam May'22) (MTP May'23)

Nikka Limited has obtained a term loan of ₹ 620 lacs for a complete renovation and modernisation of its Factory on 1st April, 20X1. Plant and Machinery was acquired under the modernisation scheme and installation was completed on 30th April, 20X2. An expenditure of ₹ 510 lacs was incurred on installation of Plant and Machinery, ₹ 54 lacs has been advanced to suppliers for additional assets (acquired on 25th April, 20X1) which were also installed on 30th April, 20X2 and the balance loan of ₹ 56 lacs has been used for working capital purposes. Management of Nikka Limited considers the 12 months period as substantial period of time to get the asset ready for its intended use.

The company has paid total interest of ₹ 68.20 lacs during financial year 20X1-20X2 on the above loan. The accountant seeks your advice how to account for the interest paid in the books of accounts. Will your answer be different, if the whole process of renovation and modernization gets completed by 28th February, 20X2?

(7 Marks)

Solution

As per Ind AS 23, 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.

Where, a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Accordingly, the treatment of Interest of ₹ 68.20 lacs occurred during the year 20X1-20X2 would be as follows:

(i) When construction of asset completed on 30th April, 20X2

The treatment for total borrowing cost of ₹ 68.20 lakh will be as follows:

Purpose	Nature	Interest to be capitalised	Interest to be charged to profit and loss account
		₹ in lakh	₹ in lakh
Modernization and renovation of plant and machinery	Qualifying asset	$[68.20 \times (510/620)] = 56.10$	
Advance to Suppliers for additional assets	Qualifying asset	$[68.20 \times (54/620)] = 5.94$	
Working Capital	Not a qualifying asset		$[68.20 \times (56/620)] = 6.16$
		62.04	6.16

(ii) When construction of assets is completed by 28th February, 20X2

When the process of renovation gets completed in less than 12 months, the plant and machinery and the additional assets will not be considered as qualifying assets (until and unless the entity specifically considers that the assets took substantial period of time for completing their construction). Accordingly, the whole of interest will be required to be charged off / expensed off to Profit and loss account.

Illustration 18

Is interest on a finance lease of a qualifying asset capitalised as borrowing costs?

Solution:

Yes, interest incurred for a finance lease is specific to an asset. Interest is capitalised if the asset is a qualifying asset or is used solely for the construction of a qualifying asset. For example, a crane or a dockyard is leased for the purpose of constructing a ship. The ship is a qualifying asset. The interest on the finance lease of the crane or dockyard is capitalised as borrowing costs. Borrowing costs on the finance lease can only be capitalised up to the point when the construction of the qualifying asset is complete.

Illustration 19

A subsidiary (or jointly controlled entity or associate) finances the construction of a qualifying asset with an inter-company loan. Are borrowing costs incurred on the inter-company loan capitalised in the separate financial statements of the subsidiary (or jointly controlled entity or associate)?

Solution:

Yes. Borrowing costs are capitalised to the extent of the actual costs incurred by the subsidiary (or jointly controlled entity or associate).

Question 1 - (Past Exam Nov'19), (MTP March'21)

An entity constructs a new office building commencing on 1st September, 2018, which continues till 31st December, 2018 (and is expected to go beyond a year). Directly attributable expenditure at the beginning of the month on this asset are ₹ 2 lakh in September 2018 and ₹ 4 lakh in each of the months of October to December 2018.

The entity has not taken any specific borrowings to finance the construction of the building but has incurred finance costs on its general borrowings during the construction period. During the year, the entity had issued 9% debentures with a face value of ₹ 30 lakh and had an overdraft of ₹ 4 lakh, which increased to ₹ 8 lakh in December 2018. Interest was paid on the overdraft at 12% until 1st October, 2018 and then the rate was increased to 15%.

Calculate the capitalization rate for computation of borrowing cost in accordance with Ind AS 'Borrowing Cost'.
(8 Marks)

Solution:

Calculation of capitalization rate on borrowings other than specific borrowings

Nature of general borrowings	Period of outstanding balance	Amount of loan (₹)	Rate of interest p.a.	Weighted average amount of interest (₹)
	a	b	c	$d = [(b \times c) \times (a/12)]$
9% Debentures	12 months	30,00,000	9%	2,70,000
Bank overdraft	9 months	4,00,000	12%	36,000
	2 months	4,00,000	15%	10,000
	1 month	8,00,000	15%	10,000
		<u>46,00,000</u>		<u>3,26,000</u>

Weighted average cost of borrowings

$$= \{30,00,000 \times (12/12)\} + \{4,00,000 \times (11/12)\} + \{8,00,000 \times (1/12)\}$$

$$= 34,33,334$$

Capitalisation rate = (Weighted average amount of interest / Weighted average of general borrowings) x 100

$$= (3,26,000 / 34,33,334) \times 100 = 9.50\% \text{ p.a.}$$

Question 2 (RTP May'22)

X Ltd. commenced the construction of a plant (qualifying asset) on 1st September, 20X1, estimated to cost ₹ 10 crores. For this purpose, X has not raised any specific borrowings, rather it intends to use general borrowings, which have a weighted average cost of 11%. Total borrowing costs incurred during the period, viz., 1st September, 20X1 to 31st March, 20X2 were ₹ 0.5 crore.

The other relevant details are as follows: (₹ in crore)

Month	Cost of construction Accrued	Cash outflows (paid in advance at the start of each month)
September	1.50	3.00

October	0.50	1.70
November	1.50	2.50
December	0.50	-
January	1.80	1.00
February	0.70	-
March	3.00	1.50

Based on the above information, discuss the treatment of borrowing cost as per cash outflow basis and accrual basis and also suggest the appropriate amount of interest that should be capitalised to the cost of the plant in the financial statements for the year ended 31st March, 20X2?

Solution

Paragraph 14 of Ind AS 23, inter-alia, states that 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 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.

In this context, a question arises whether such expenditure should be based on costs accrued or actual cash outflows. To contrast these two alternatives, presented below is the computation of borrowing costs based on both the alternatives:

Month	Cost of construction Accrued	Average capital expenditure	Cash outflows (paid in advance at the start of each month)	Average capital expenditure
September	1.50	$1.50 \times 7/12 = 0.875$	3.00	$3.00 \times 7/12 = 1.75$
October	0.50	$0.50 \times 6/12 = 0.25$	1.70	$1.70 \times 6/12 = 0.85$
November	1.50	$1.50 \times 5/12 = 0.625$	2.50	$2.50 \times 5/12 = 1.04$
December	0.50	$0.50 \times 4/12 = 0.17$	-	-
January	1.80	$1.80 \times 3/12 = 0.45$	1.00	$1 \times 3/12 = 0.25$
February	0.70	$0.70 \times 2/12 = 0.12$	-	-
March	3.00	$3.00 \times 1/12 = 0.25$	1.50	$1.50 \times 1/12 = 0.125$
	9.50	2.74	9.70	4.02

If the average capital expenditure on the basis of costs accrued is taken, the borrowing costs eligible to be capitalised would be ₹ 2.74 crore $\times$ 11% = 0.30 crore. Whereas, if average capital expenditure on the basis of cash flows is taken, the borrowing costs eligible to be capitalised would be ₹ 4.02 crore $\times$ 11% = 0.44 crore. Thus, there is a wide variance in the amount of borrowing cost to be capitalised, based on the accrual basis and on actual cash flows basis. This divergence is often experienced during the implementation of large projects, for example, an advance given to a supplier involves an upfront cash outflow while the actual expenditure accrues in later periods (with the receipt of goods and services).

As per paragraph 18 of Ind AS 23, expenditures 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 capitalization rate is applied in that period.

Where cash has been paid but the corresponding cost has not yet accrued interest becomes payable on payment of cash. Therefore, the amount so paid should be considered for determining the amount of interest eligible for capitalisation, subject to the fulfillment of other conditions prescribed in paragraph 16 of Ind AS 23. Accordingly, in the present case, interest should be computed on the basis of the cash flows rather than on the basis of costs accrued. Therefore, the amount of interest eligible for capitalisation would be ₹ 0.44 crore.

Another important factor to be noted is that paragraph 14 requires, inter alia, that 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. Thus, the amount of borrowing costs to be capitalised should not exceed the total borrowing costs incurred during the period, that is ₹ 0.5 crore.

Question 3 (RTP Nov'22)

Harish Construction Company is constructing a huge building project consisting of four phases. It is expected that the full building will be constructed over several years but Phase I and Phase II of the building will be operational as soon as they are completed.

Following is the detail of the work done on different phases of the building during the current year:

(₹ in lakh)

	Phase I	Phase II	Phase III	Phase IV
	₹	₹	₹	₹
Cash expenditure	10	30	25	30
Building purchased	24	34	30	38
Total expenditure	34	64	55	68
Total expenditure of all phases				221
Loan taken @ 15% at the beginning of the year				200

After taking substantial period of construction, at the mid of the current year, Phase I and Phase II have become operational. Find out the total amount to be capitalized and to be expensed during the year.

Solution:

	Particulars	₹
1	Interest Expense on loan ₹ 2,00,00,000 at 15 %	30,00,000
2	Total cost of Phases I and II (₹ 34,00,000 + ₹ 64,00,000)	98,00,000
3	Total cost of Phases III and IV (₹ 55,00,000 + ₹ 68,00,000)	1,23,00,000
4	Total cost of all 4 phases	2,21,00,000
5	Total Loan	2,00,00,000
6	Interest on loan used for Phases I & II, based on proportionate loan amount (30,00,000 / 2,21,00,000) × 98,00,000	13,30,317 (approx.)
7	Interest on loan used for Phases III & IV, based on proportionate loan amount (30,00,000 / 2,21,00,000) × 1,23,00,000	16,69,683 (approx.)

Accounting treatment:

1. For Phase I and Phase II

Since Phase I and Phase II have become operational at mid of the year, half of the interest amount of ₹ 6,65,158.50 (i.e. ₹ 13,30,317/2) relating to Phase I and Phase II should be capitalized (in the ratio of asset

costs 34:64) and added to respective assets in Phase I and Phase II and remaining half of the interest amount of ₹ 6,65,158.50 (i.e. ₹ 13,30,317/2) relating to Phase I and Phase II should be expensed off during the year.

2. For Phase III and Phase IV

Interest of ₹ 16,69,683 relating to Phase III and Phase IV should be held in Capital Work-in-Progress till assets construction work is completed, and thereafter capitalized in the ratio of cost of assets. No part of this interest amount should be charged/expensed off during the year since the work on these phases has not been completed yet.

Question 4 (RTP May'23, MTP May'24)

LT Ltd. is in the process of constructing a building. The construction process is expected to take about 18 months from 1st January 20X1 to 30th June 20X2. The building meets the definition of a qualifying asset. LT Ltd. incurs the following expenditure for the construction:

1st January, 20X1	₹ 5 crores
30th June, 20X1	₹ 20 crores
31st March, 20X2	₹ 20 crores
30th June, 20X2	₹ 5 crores

On 1st July 20X1, LT Ltd. issued 10% Redeemable Debentures of ₹ 50 crores. The proceeds from the debentures form part of the company's general borrowings, which it uses to finance the construction of the qualifying asset, i.e. the building. LT Ltd. had no borrowings (general or specific) before 1st July 20X1 and did not incur any borrowing costs before that date. LT Ltd. incurred ₹ 25 crores of construction costs before obtaining general borrowings on 1st July 20X1 (pre-borrowing expenditure) and ₹ 25 crores after obtaining the general borrowings (post-borrowing expenditure).

For each of the financial years ended 31st March 20X1, 20X2 and 20X3, calculate the borrowing cost that LT Ltd. is permitted to capitalize as a part of the building cost. (8 Marks)

Solution:

Applying paragraph 17 of Ind AS 23 to the fact pattern, the entity would not begin capitalising borrowing costs until it incurs borrowing costs (i.e. from 1st July, 20X1)

In determining the expenditures on a qualifying asset to which an entity applies the capitalisation rate (paragraph 14 of Ind AS 23), the entity does not disregard expenditures on the qualifying asset incurred before the entity obtains the general borrowings. Once the entity incurs borrowing costs and therefore satisfies all three conditions in para 17 of Ind AS 23, it then applies paragraph 14 of Ind AS 23 to determine the expenditures on the qualifying asset to which it applies the capitalization rate.

Calculation of borrowing cost for financial year 20X0-20X1

Expenditure		Capitalization Period (current year)	Weighted average Accumulated Expenditure
Date	Amount		
1st January 20X1	₹ 5 crore	0/3	Nil

Borrowing Costs eligible for capitalisation = NIL. LT Ltd. cannot capitalise borrowing costs before 1st July, 20X1 (the day it starts to incur borrowing costs).

Calculation of borrowing cost for financial year 20X1-20X2

Expenditure		Capitalization Period (current year)	Weighted average Accumulated Expenditure

Date	Amount		
1st January, 20X1	₹ 5 crore	9/12*	₹ 3.75 crore
30th June, 20X1	₹ 20 crore	9/12	₹ 15 crore
31st March, 20X2	₹ 20 crore	0/12	Nil
Total			₹ 18.75 crore

Borrowing Costs eligible for capitalisation = 18.75 cr. x 10% = ₹ 1.875 cr.

*LT Ltd. cannot capitalise borrowing costs before 1st July, 20X1 (the day it starts to incur borrowing costs). Accordingly, this calculation uses a capitalization period from 1st July, 20X1 to 31st March, 20X2 for this expenditure.

Calculation of borrowing cost for financial year 20X2-20X3

Expenditure		Capitalization Period (current year)	Weighted average Accumulated Expenditure
Date	Amount		
1st January, 20X1	₹ 5 crore	3/12	₹ 1.25 crore
30th June, 20X1	₹ 20 crore	3/12	₹ 5 crore
31st March, 20X2	₹ 20 crore	3/12	₹ 5 crore
30th June, 20X2	₹ 5 crore	0/12	Nil
Total			₹ 11.72 crore

Borrowing costs eligible for capitalisation = ₹ 11.72 cr. x 10% = ₹ 1.172 cr.

Note: The same question was asked in MTP May 24 but, borrowing cost on highlighted part was not considered in Year X2-X3. In Exam to be on a safer side you can give alternative solution as well.

Question 5 (RTP May'24)

PQR Limited is engaged in Tourism business in India. The company has planned to construct a Holiday Resort (Qualifying Asset) at Shimla. The cost of the project has been met out of borrowed funds of ₹ 100 lakhs at the rate of 12% p.a. ₹ 40 lakhs were disbursed on 1st April 20X2 and the balance of ₹ 60 lakhs were disbursed on 1st June 20X2. The site planning work commenced on 1st June 20X2, since the Chief engineer of the project was on medical leave. The company commenced physical construction on 1st July 20X2 and the work of construction continued till 30th September 20X2 and thereafter the construction activities stopped due to landslide on the road which leads to construction site. The road blockages have been cleared by the government machinery by 31st December 20X2. Construction activities have resumed on 1st January 20X3 and has completed on 28th February 20X3.

The date of opening has been scheduled for 1st March 20X3, but unfortunately, the District Administration gave permission for opening on 16th March 20X3, due to lack of safety measures like fire extinguishers which had not been installed by then.

Determine the amount of borrowing cost to be capitalized towards construction of the resort when

(i) Landslide is not common in Shimla and delay in approval from District Administration Office is minor administrative work leftover.

(ii) Landslide is common in Shimla and delay in approval from District Administration Office is major administrative work leftover.

Solution:

As per Ind AS 23 'Borrowing Costs', the commencement date for capitalisation of borrowing cost on qualifying asset 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; and
- (c) it undertakes activities that are necessary to prepare the asset for its intended use or sale.

Further, an entity also does not 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, capitalization 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.

An entity shall cease capitalising borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

Further, paragraph 23 explains that 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.

In the given case since the site planning work started for the project on 1st June, 20X2, the commencement of capitalisation of borrowing cost will begin from 1st June, 20X2.

(i) When landslide is not common in Shimla and delay in approval from District Administration Office is minor administrative work leftover

In such a situation, suspension of capitalisation of borrowing cost on construction work will be considered for 3 months i.e. from October, 20X2 to December, 20X2 and cessation of capitalization of borrowing cost shall stop at the time of completion of physical activities.

Accordingly, the borrowing cost to be capitalized will be effectively for 6 months i.e. from 1st June, 20X2 to 30th September, 20X2 and then from 1st January, 20X3 to 28th February, 20X3 i.e. total 6 months. The amount of borrowing cost will be ₹ 6,00,000 ($1,00,00,000 \times 6/12 \times 12\%$).

(ii) When landslide is common in Shimla and delay in approval from District Administration Office is major administrative work leftover

Since landslides are common in Shimla during monsoon period, there shall be no suspension of capitalisation of borrowing cost during that period.

Further, an asset can be considered to be ready for its intended use only on receipt of approvals and after compliance with regulatory requirements such as "Fire Clearances" etc. These are very important to declare the asset as ready for its scheduled operation.

In the given case, obtaining the safety approval is a necessary condition that needs to be complied with strictly and before obtaining the same the entity will not be able to use the building.

Accordingly, it is appropriate to continue capitalisation until the said approvals are obtained.

Hence, the capitalisation of the borrowing cost will be for 9.5 months i.e. from 1st June, 20X2 till 15th March, 20X3. The amount of borrowing cost will be ₹ 9,50,000 ($1,00,00,000 \times 9.5/12 \times 12\%$).

SOLVED EXAMPLE

Example 1 (MTP Nov' 23) (In MTP Only Exchange loss part was asked) – (6 Marks)

An entity can borrow funds in its functional currency (₹) @ 12%. It borrows \$ 1,000 @ 4% on April 1, 20X1 when \$ 1 = ₹ 40. The equivalent amount in functional currency is Rs. 40,000. Interest is payable on March 31, 20X2. On March 31, 20X2, exchange rate is \$ 1 = ₹ 50. The loan is not due for repayment. The exchange loss in this case is ₹ 10,000 [$\$ 1,000 \times (\text{₹ } 50 - \text{₹ } 40)$]. The borrowing cost is ₹ 2,000 ($\$ 1,000 \times 4\% \times \text{₹ } 50$). Had the entity borrowed in functional currency the borrowing cost would have been ₹ 4,800 ($\text{₹ } 40,000 \times 12\%$). The entity will treat exchange difference upto ₹ 2,800 ($\text{₹ } 4,800 - \text{₹ } 2,000$) as a borrowing cost that may be eligible for capitalisation under this Standard. Thus, the total eligible borrowing cost is ₹ 4,800 ($\text{₹ } 2,000 + \text{₹ } 2,800$) equivalent to the cost of borrowing cost in functional currency.

If the exchange rate on March 31, 20X2, is \$ 1 = ₹ 41.

The exchange loss is ₹ 1,000 [$\$ 1,000 - (\text{₹ } 41 - \text{₹ } 40)$]. The entity will treat the entire exchange loss as an eligible borrowing cost as total cost of the borrowing ₹ 2,640 [$(\text{₹ } 1,000 \times 4\% \times 41) + \text{₹ } 1,000$] in foreign currency does not exceed the cost of borrowings in functional currency, i.e., ₹ 4,800.

Continuing with the aforesaid example:

Case A: If the exchange rate on March 31, 20X3, is \$ 1 = ₹ 48;

the exchange rate on March 31, 20X2, being \$ 1 = ₹ 50, the borrowings are still not due for payment. The entity will recognise a borrowing cost of ₹ 1,920 ($\$ 1,000 \times 4\% \times \text{₹ } 48$). There is an exchange gain of ₹ 2,000 ($\$ 1,000 \times (\text{₹ } 50 - \text{₹ } 48)$). 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.

Case B: If the exchange rate on March 31, 20X3, is \$ 1 = ₹ 44;

the exchange rate on March 31, 20X2, being \$ 1 = ₹ 50, the borrowings are still not due for payment. The entity will recognise a borrowing cost of ₹ 1,760 ($\$ 1,000 \times 4\% \times \text{₹ } 44$). There is an exchange gain of ₹ 6,000 [$\$ 1,000 \times (\text{₹ } 50 - \text{₹ } 44)$]. 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.

Case C: If the exchange rate on March 31, 20X3, is \$ 1 = ₹ 44 and part of loan is repaid;

the exchange rate on March 31, 20X2, being \$ 1 = ₹ 50; \$ 600 of the borrowings was paid on March 31, 20X2, \$ 400 of the borrowings are still not due for payment. The entity will recognise a borrowing cost of ₹ 704 ($\$ 400 \times 4\% \times \text{₹ } 44$). There is an exchange gain of ₹ 2400 [$\$ 400 \times (\text{₹ } 50 - \text{₹ } 44)$]. The unrealised exchange loss of earlier year is ₹ 4,000 [$\$ 400 \times (\text{₹ } 50 - \text{₹ } 40)$] out of which ₹ 1,120 ($\text{₹ } 2,800 \times \$ 400 / \$ 1,000$) was charged in March 31, 20X1, as borrowing cost. Thus, there will be an adjustment in the borrowing cost upto ₹ 1,120 as this is unrealised exchange loss.

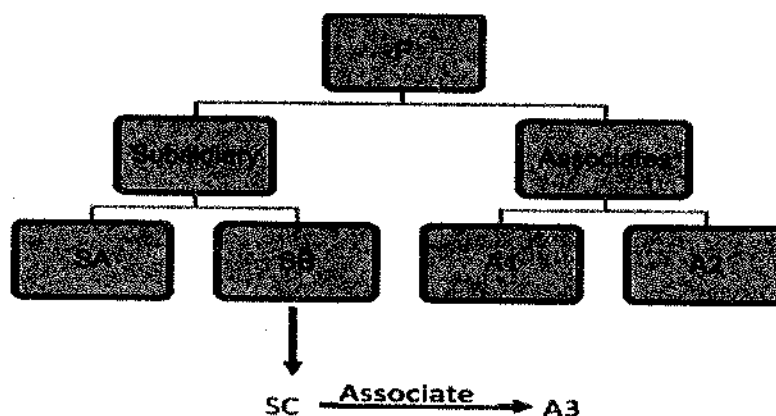
IND AS 24 – RELATED PARTY DISCLOSURES

Illustration 1

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.
- For Parent's consolidated financial statements, A1 Limited, A2 Limited and A3 Limited are related to the Group.

Illustration 2 – (MTP Nov'21)

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.

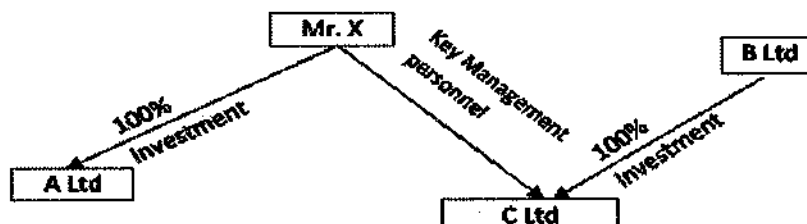
Required

- Examine related party relationships from the perspective of C Limited for A Limited.
- 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.
- Will the outcome in (a) & (b) would be different if Mr. X has joint control over A Limited.
- Will the outcome in (a) & (b) would be different if Mr. X has significant influence over A Limited.

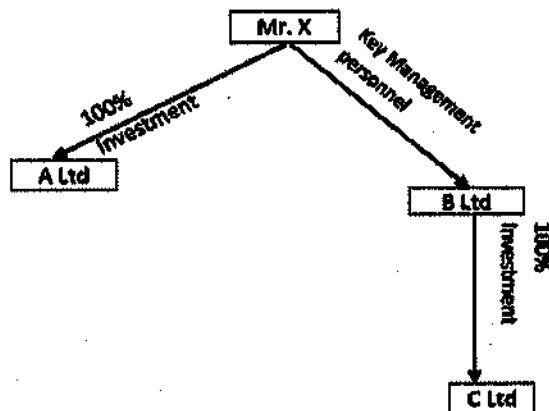
(4 Marks)

Solution

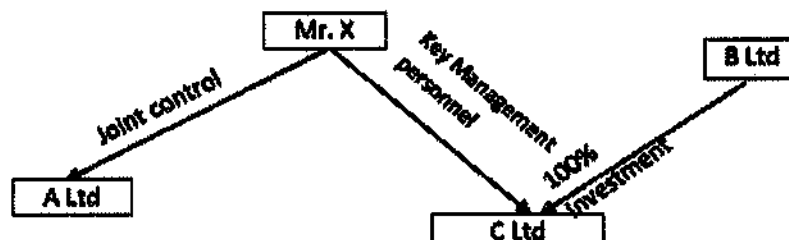
- A Limited is related to C Limited because Mr. X controls A Limited and is a member of KMP of C Limited.



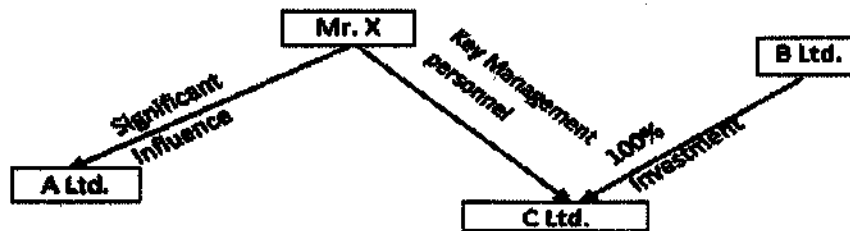
- Still A limited will be related to C limited



- No, Still A Limited will be related to C Limited



- Yes, A Limited is not controlled by Mr. X. Therefore, despite Mr. X being KMP of C Limited, A limited having significant influence of Mr. X, will not be considered as related party of C Limited.

**Illustration 3 (Past Exam May'23)**

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? **(5 Marks)**

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.

Illustration 4

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.

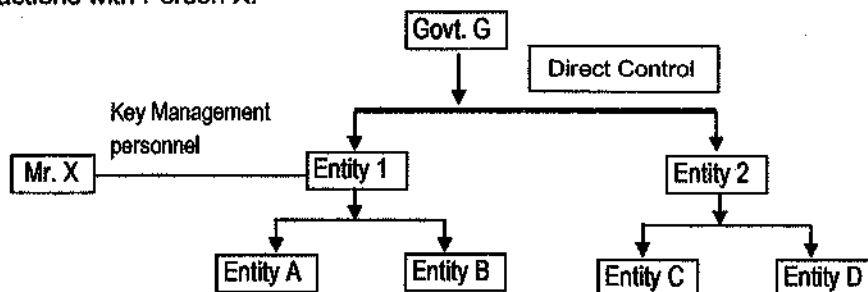


Illustration 5

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, 20 X2 make related party disclosures for the period from July 15, 20X1 to March 21, 20X2 when Transmission Limited was its subsidiary.

Illustration 6 (MTP April'22)

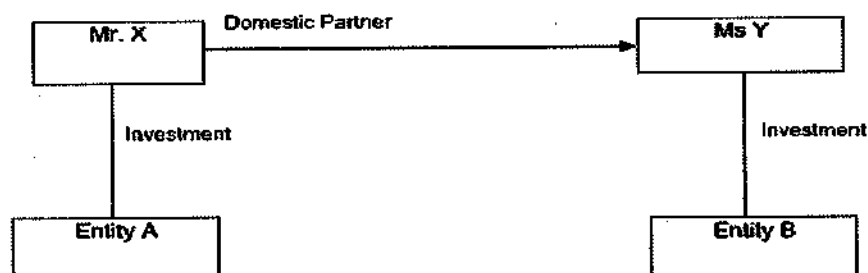
Mr. X is a domestic partner of Ms. Y. Mr. X has an investment in A Limited and Ms. Y has an investment in B Limited.

Required

- Examine when can a related party relationship is established, from the perspective of A Limited's financial statements:
- Examine when can related party relationship is established, from the perspective of B Limited's financial statements:
- 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. **(5 Marks)**

Solution

- 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.
- 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.
- No, Significant influence does not lead to direct/indirect control between the A Ltd. & B Ltd.



If Mr X is a member of the key management personnel of Entity A and Ms Y is a member of the key management personnel of Entity B, Entities A and B are not, in the absence of any other indicator of a related party relationship, related to each other.

Illustration 7

A Limited has both (i) joint control over B Limited and (ii) joint control or significant influence over C Limited

Required

- Examine related party relationship from the perspective of C Limited's financial statements.
- Examine related party relationship from the perspective of B Limited's financial statements.

Solution

- (a) C Limited is related to B Limited
 (b) B Limited is related to C Limited

Illustration 8 - (MTP - Oct 2020)

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, 20X2 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. **(5 Marks)**

Solution

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.

Illustration 9

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?

Solution

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.

Illustration 10

Mr. X, is the financial controller of ABC Ltd., a listed entity which prepares consolidated financial statements in accordance with Ind AS. Mr. X has recently produced the final draft of the financial statements of ABC Ltd. for the year ended 31st March, 20X2 to the managing director Mr. Y for approval. Mr. Y, who is not an accountant, had raised following query from Mr. X after going through the draft financial statements:

One of the notes to the financial statements gives details of purchases made by ABC Ltd. from PQR Ltd. during the period 20X1-20X2. Mr. Y owns 100% of the shares in PQR Ltd. However, he feels that there is no requirement for any disclosure to be made in ABC Ltd.'s financial statements since the transaction is carried out on normal commercial terms and is totally insignificant to ABC Ltd., as it represents less than 1% of ABC Ltd.'s purchases.

Provide answers to the query raised by the Managing Director Mr. Y as per Ind AS.

Solution:

Ongoing through the queries raised by the Managing Director Mr. Y, the financial controller Mr. X explained the notes and reasons for their disclosures as follows:

Related parties are generally characterised by the presence of control or influence between the two parties.

Ind AS 24 'Related Party Disclosures' identifies related parties as, inter alia, key management personnel and companies controlled by key management personnel. On this basis, PQR Ltd. is a related party of ABC Ltd.

The transaction is required to be disclosed in the financial statements of ABC Ltd. since Mr. Y is Key Management personnel of ABC Ltd. Also at the same time, it owns 100% shares of PQR Ltd. i.e. he controls PQR Ltd. This implies that PQR Ltd. is a related party of ABC Ltd.

Where transactions occur with related parties, Ind AS 24 requires that details of the transactions are disclosed in Notes to the financial statements. This is required even if the transactions are carried out on an arm's length basis.

Transactions with related parties are material by their nature, so the fact that the transaction may be numerically insignificant to ABC Ltd. does not affect the need for disclosure.

Illustration 11

Uttar Pradesh State Government holds 60% shares in PQR Limited and 55% shares in ABC Limited. PQR Limited has two subsidiaries namely P Limited and Q Limited. ABC Limited has two subsidiaries namely A Limited and B Limited. Mr. KM is one of the Key management personnel in PQR Limited.

- a) Determine the entity to whom exemption from disclosure of related party transactions is to be given. Also examine the transactions and with whom such exemption applies.
- b) What are the disclosure requirements for the entity which has availed the exemption?

Solution:

- a) As per para 18 of Ind AS 24, 'Related Party Disclosures', if an entity had related party transactions during the periods covered by the financial statements, it shall disclose the nature of the related party relationship as well as information about those transactions and outstanding balances, including commitments, necessary for users to understand the potential effect of the relationship on the financial statements.

However, as per para 25 of the standard a reporting entity is exempt from the disclosure requirements in relation to related party transactions and outstanding balances, including commitments, with:

- i) a government that has control or joint control of, or significant influence over, the reporting entity; and
- ii) another entity that is a related party because the same government has control or joint control of, or significant influence over, both the reporting entity and the other entity

According to the above paras, for Entity P's financial statements, the exemption in paragraph 25 applies to:

- i) transactions with Government Uttar Pradesh State Government; and
- ii) transactions with Entities PQR and ABC and Entities Q, A and B.

Similar exemptions are available to Entities PQR, ABC, Q, A and B, with the transactions with UP State Government and other entities controlled directly or indirectly by UP State Government. However, that exemption does not apply to transactions with Mr. KM. Hence, the transactions with Mr. KM needs to be disclosed under related party transactions.

- b) It shall disclose the following about the transactions and related outstanding balances referred to in paragraph 25:
 - i) the name of the government and the nature of its relationship with the reporting entity (ie control, joint control or significant influence);
 - ii) the following information in sufficient detail to enable users of the entity's financial statements to understand the effect of related party transactions on its financial statements:
 - the nature and amount of each individually significant transaction; and
 - for other transactions that are collectively, but not individually, significant, a qualitative or quantitative indication of their extent.

Illustration 12

S Ltd., a wholly owned subsidiary of P Ltd is the sole distributor of electricity to consumers in a specified geographical area. A manufacturing facility of P Ltd is located in the said geographical area and, accordingly, P Ltd is also a consumer of electricity supplied by S Ltd. The electricity tariffs for the geographical area are determined by an independent rate-setting authority and are applicable to all consumers of S Ltd, including P Ltd. Whether the above transaction is required to be disclosed as a related party transaction as per Ind AS 24, Related Party Disclosures in the financial statements of S Ltd.?

Solution:

As per paragraph 9(b)(i) of Ind AS 24, each parent, subsidiary and fellow subsidiary in a 'group' is related to the other members of the group. Thus, in the case under discussion, P Ltd is a related party of S Ltd from the perspective of financial statements of S Ltd.

Paragraph 11 of Ind AS 24 states as follows:

"In the context of this Standard, the following are not related parties:

- (a) two entities simply because they have a director or other member of management personnel in common or because a member of key management personnel of one entity has significant influence over the other entity.
- (b) two joint venturers simply because they share joint control of 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, 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."

Being engaged in distribution of electricity, S Ltd is a public utility. Had the only relationship between S Ltd and P Ltd been that of a supplier and a consumer of electricity, P Ltd would not have been regarded as a related party of S Ltd. However, as per the facts of the given case, this is not the only relationship between S Ltd and P Ltd. Apart from being a supplier of electricity to P Ltd., S Ltd is also a subsidiary of P Ltd; this is a relationship that is covered within the related party relationships to which the disclosure requirements of the standard apply. In view of the above, the supply of electricity by S Ltd to P Ltd is a related party transaction that attracts the disclosure requirements contained in paragraph 18 and other relevant requirements of the standard. This is notwithstanding the fact that P Ltd is charged the electricity tariffs determined by an independent rate-setting authority (i.e., the terms of supply to P Ltd are at par with those applicable to other consumers)

Ind AS 24 does not exempt an entity from disclosing related party transactions merely because they have been carried out on an arm's length basis.

Question 1 - (MTP – March'19)

An Indian company has a parent company outside India. Parent company negotiates software licenses with end vendor and based on number of licences, parent company get its reimbursement from Indian company. Say, license cost of Rs. 12 Lac is charged for calendar year of 2018. Parent company generates invoice in February'18. Indian company accounts full invoice in February'18 and then for Indian financial year, accounts Reimbursement expense of Rs. 3.00 Lac during FY 1718 (for licencing cost relating to period January'18 to March'18) and Prepaid expenses of Rs.9 Lac for licensing cost reimbursement relating to April'18 to December'18. Prepaid expense is subsequently reversed and expense of Rs. 9 Lac is accounted for in FY 18-19.

What amount should be disclosed at Related party transaction?

Solution:

Paragraph 9 of Ind AS 24 Related Party Disclosures defines Related Party Transactions as under:

"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."

Paragraph 6 of Ind AS 24 states as under: "A related party relationship could have an effect on the profit or loss and financial position of an entity..."

In the given case, there is a transfer of resources to the extent of Rs.12 lac from the company to the parent towards software license. Of this transfer of resources, the company has consumed the benefits relating to Rs.3 lac of software license cost which is recognise in profit or loss. The benefits relating to Rs.9 lac of software license cost will be consumed in the next reporting period and therefore is recognised in balance sheet as prepaid expenses.

Paragraph 18 of Ind AS 24 states as under: "If an entity has had related party transactions during the periods covered by the financial statements, it shall disclose the nature of the related party relationship as well as information about those transactions and outstanding balances, including commitments necessary for users to understand the potential effect of the relationship of the financial statements. At a minimum, disclosures shall include:

- a. The amount of the transactions;
- b. The amount of outstanding balances, including commitments, and;
 - (i) Their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and
 - (ii) Details of any guarantees given or received;
- c. Provisions for doubtful debts related to the amount of outstanding balances; and
- d. The expense recognised during the period in respect of bad and doubtful debts due from related parties."

Therefore, the company has to disclose:

1. The amount of transaction with the parent of Rs.12 lac towards software license;
2. Outstanding balance of Rs.9 lac presented as prepaid expense along with the terms and conditions and state that the same will be settled in the next reporting period by receipt of software licensing services.
3. The amount of Rs.3 lac recognised as software license expense in profit or loss for the benefits consumed during the period to make it understandable to users.

Paragraph 113 of Ind AS 1 Presentation of Financial Statements states as under:

"113 An entity shall present notes in a systematic manner. An entity shall cross-reference each line items in the balance sheet and in the statement of profit and loss, and in the statement of changes in equity and of cash flows to any related information in the notes."

Therefore, the company shall cross-reference the software license expense recognised in profit or loss and prepaid expenses recognised in balance sheet to the notes disclosing related party transactions.

Question 2 (RTP Nov'20)

Mr. X owns 95% of entity A and is its director. He is also beneficiary of a trust that owns 100% of entity B, of which he is a director.

Whether entities A and B are related parties?

Would the situation be different if:

- Mr. X resigned as a director of entity A, but retained his 95% holding?
- Mr. X resigned as a director of entities A and B and transferred the 95% holding in entity A to the trust?

Solution:

Entities A and B are related parties, because the director (Mr. X) controls entity A and is a member of the key management personnel of entity B.

Answers to different given situations would be as under:

a) Mr. X resigned as a director of entity A, but retained his 95% holding

Mr. X continues to control entity A through his 95% holding even though he is not (nominally) a director of the entity. Entities A and B are related if Mr. X controls the trust. Mr. X controls entity A and also, through the trust, controls entity B. Entities A and B are controlled by the same person, and so they are related parties.

Mr. X might still be a member of 'key management personnel' even though he is not (nominally) a director of entity A. Key management personnel includes, but is not restricted to, directors, which include those who are executive 'or otherwise' provided they had authority and responsibility for planning, directing and controlling the activities of the entity. There could be two reasons why entities A and B would continue to be related parties: Mr. X being a member of 'Key management personnel' of entity A and Mr. X controlling entity A.

b) Mr. X resigned as a director of entities A and B and transferred the 95% holding in entity A to the trust.

If Mr. X controls the trust, he controls entities A and B through the trust, so they will be related parties (see reason in (a) above)

Mr. X is a member of 'key management personnel' of the two entities (see (a) above) if, as seems likely, he continues to direct their operating and financial policies. The substance of the relationship and not merely the legal form should be considered. If Mr X is regarded as a member of the key management personnel of, say, entity A, entity B is a related party, because he exercises control or significant influence over entity B by virtue of his control over the trust.

Question 3 (RTP May'22)

Entity A owns 30% of the share capital of entity B and has the ability to exercise significant influence over it.

Entity B holds the following investments:

- 70% of the share capital of its subsidiary, entity C; and
- 30% of the share capital of entity D, with the ability to exercise significant influence.

Entity A transacts with entities C and D. Should entity A disclose these transactions as related party transactions in its separate financial statements? Also explain the disclosure of such transactions in the financial statements of C and D as related party transaction.

Solution:

Entity A should disclose its transactions with entity C in entity A's separate financial statements. Entity C is a related party of entity A, because entity C is the subsidiary of entity A's associate, entity B.

Entity A's management is not required to disclose entity A's transactions with entity D in its financial statements. Entity D is not a related party of entity A, because entity A has no ability to exercise control or significant influence over entity D.

Entity C is required to disclose its transactions with entity A in its financial statements, because entity A is a related party.

Entity D is not required to disclose transactions with entity A, because they are not related parties.

Question 4 (RTP May 23)

SEL has applied for a term loan from a bank for business purposes. As per the loan agreement, the loan required a personal guarantee of one of the directors of SEL to be executed. In case of default by SEL, the director will be required to compensate for the loss that bank incurs. Mr. Pure Joy, one of the directors had given guarantee to the bank pursuant to which the loan was sanctioned to SEL. SEL does not pay premium or fees to its director for providing this financial guarantee.

Whether SEL is required to account for the financial guarantee received from its director? Will there be any disclosures under Ind AS 24?

Solution:

Ind AS 109 'Financial Instruments', defines a financial guarantee contract as 'a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.'

Based on this definition, an evaluation is required to be done to ascertain whether the contract between director and Bank qualifies as a financial guarantee contract as defined in Appendix A to Ind AS 109. In the given case, it does qualify as a financial guarantee contract as:

- ❖ the reference obligation is a debt instrument (term loan);
- ❖ the holder i.e. Bank is compensated only for a loss that it incurs (arising on account of non-repayment); and
- ❖ the holder is not compensated for more than the actual loss incurred.

Ind AS 109 provides principles for accounting by the issuer of the guarantee.

However, it does not specifically address the accounting for financial guarantees by the beneficiary. In an arm's length transaction between unrelated parties, the beneficiary of the financial guarantee would recognise the guarantee fee or premium paid as an expense.

It is also pertinent to note that the entity needs to exercise judgment in assessing the substance of the transaction taking into consideration relevant facts and circumstances, for example, whether the director is being compensated otherwise for providing guarantee. Based on such an assessment, an appropriate accounting treatment based on the principles of Ind AS should be followed.

In the given case, SEL is the beneficiary of the financial guarantee and it does not pay a premium or fees to its director for providing this financial guarantee. Accordingly, SEL will not be required to account for such financial guarantee in its financial statements considering the unit of account as being the guaranteed loan, in which case the fair value would be expected to be the face value of the loan proceeds that SEL received.

In the given case based on the limited facts provided, SEL will be required to make necessary disclosures of such financial guarantee in accordance with Ind AS 24 as follows:

- a) the amount of the transactions;
- b) the amount of outstanding balances, including commitments, and:
 - (i) their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and
 - (ii) details of any guarantees given or received;
- c) provisions for doubtful debts related to the amount of outstanding balances; and
- d) the expense recognised during the period in respect of bad or doubtful debts due from related parties.

IND AS 33 – EARNINGS PER SHARE

Illustration 1

ABC Ltd. issues 9% preference shares of fair value of ₹10 each on 1.4.20X1. Total value of the issue is ₹10,00,000. The shares are issued for a period of 5 years and would be redeemed at the end of 5th year. The shares are to be redeemed at ₹11 each.

At the end of the year 3, i.e. on 31.3.20X4, company finds that it has earned good returns than expected over last three years and can make the redemption of preference shares early. To compensate the shareholders for two years of dividend which they need to forego, company decided to redeem the shares at ₹12 each instead of original agreement of ₹11. Comment on the impact of early conversion of preference shares at a premium on earnings for the year 20X3- 20X4 attributable to ordinary equity holders of ABC Ltd. for basic EPS.

Ignore the applicability of the standards on Financial Instruments (i.e., ignore EIR; further, the additional payment to be made can be met from Securities Premium/Reserves as Premium on Redemption) and answer on the basis of Ind AS 33 only.

Solution

In the given situation, ₹1 per share is the excess payment made by the company amounting to ₹1,00,000 in all. The amount of ₹1,00,000 will be deducted from the earnings of the year 20X3- 20X4 while calculating the basic EPS of year 20X3-20X4.

Illustration 2

An entity has following preference shares in issue at the end of 20X4:

- **5% redeemable, non-cumulative preference shares:** These shares are classified as liabilities. During the year, an amount of Rs. 1,00,000 (computed using the coupon rate of 5% - Rs. 20,00,000 x 5%) was paid to the preference shareholders.
- **Increasing-rate, cumulative, non-redeemable preference shares issued at a discount in 20X0, with a cumulative dividend rate from 20X5 of 10%:** The shares were issued at a discount to compensate the holders, because dividend payments will not commence until 20X5. The accrual for the discount in the current year, calculated using the effective interest method amounted to, say, ₹18,000. These shares are classified as equity – ₹200,000.
- **8% non-redeemable, non-cumulative preference shares:** At the beginning of the year, the entity had ₹100,000 8% preference shares outstanding but, at 30 June 20X4, it repurchased ₹50,000 of these at a discount of ₹1,000 – ₹50,000.
- **7% cumulative, convertible preference shares (converted in the year):** These shares were classified as equity, until their conversion into ordinary shares at the beginning of the year. No dividend was accrued in respect of the year, although the previous year's dividend was paid immediately prior to conversion. To induce conversion, the terms of conversion of the 7% convertible preference shares were also amended, and the revised terms entitled the preference shareholders to an additional 100 ordinary shares on conversion with a fair value of ₹300 – Nil.

The profit attributable to ordinary equity holders for the year 20X4 is ₹150,000.

Determine the adjustments for the purpose of calculating EPS.

Solution

Adjustments for the purpose of calculating EPS are made as follows:

Particulars	Amount (₹)	Amount (₹)
Profit for the year attributable to the ordinary equity holders		150,000
Amortisation of discount on issue of increasing-rate preference shares (Refer Note 1)	(18,000)	
Discount on repurchase of 8% preference shares (Refer Note 2)	1,000	
Premium to induce Conversion	(30,000)	(17,000)
Profit attributable to ordinary equity holders for basic EPS (Refer Note 3-5)		1,33,000

Notes:

1. The original discount on issue of the increasing-rate preference shares is treated as amortised to retained earnings, and treated as preference dividends for EPS purposes and adjusted against profit attributable to the ordinary equity holders. There is no adjustment in respect of dividend, because these do not commence until 20X5. Instead, the finance cost is represented by the amortisation of the discount in the dividend-free period. In future years, the accrual for the dividend of ₹20,000 will be deducted from profits.
2. The discount on repurchase of the 8% preference shares has been credited to equity so should be added to profit.
3. The dividend on the 5% preference shares has been charged to the income statement, because the preference shares are treated as liabilities, so no adjustment is required for it from the profit.
4. No accrual for the dividend on the 8% preference shares is required, because they are non-cumulative. If a dividend had been declared for the year, it would have been deducted from profit for the purpose of calculating basic EPS, because the shares are treated as equity and the dividend would have been charged to equity in the financial statements.
5. The 7% preference shares are convertible and hence correctly classified as equity. Accordingly, the additional amount paid (100 additional shares x fair value ₹ 300 per share = ₹ 30,000) to induce conversion would be taken to Equity Share Capital and Retained Earnings or Securities Premium, as the case may be (transaction with 'owners'). Therefore, this excess amount paid would require to be deducted from the Net Profit to arrive at Net Profit attributable to Equity Shareholders.

It may be noted that as per Sections 53 and 55 of the Companies Act, 2013, a company cannot issue shares at discount or any irredeemable preference shares. However, the above illustration has been given only to explain the concept given in Ind AS

Illustration 3 – (MTP Nov'22)

Following is the data for company XYZ in respect of number of equity shares during the financial year 20X1-20X2. Find out the number of shares for the purpose of calculation of basic EPS as:

S. No.	Date	Particulars	No. of shares
1	1-Apr-20X1	Opening balance of outstanding equity shares	100,000
2	15-Jun-20X1	Issue of equity shares	75,000
3	8-Nov-20X1	Conversion of convertible preference shares in Equity	50,000
4	22-Feb-20X2	Buy back of shares	(20,000)

5	31-Mar-20X2	Closing balance of outstanding equity shares	205,000

(4 Marks)

Solution

The closing balance of the outstanding shares is 2,05,000 by a normal addition and subtraction. But as per weighted average concept, one need to find out for how many days each type of shares were actually held during the year.

The shares which were there on 1st April 20X1, were held for the whole year. Therefore, weighted average number of such shares will be given by the formula:

$$\text{No of shares} \times \text{no of days the shares were held during the year} / 365$$

$$= 1,00,000 \times 365 / 365 = 1,00,000$$

But the shares which were issued on 15th June 20X1, were held for only 290 days. Therefore, the weighted average number of shares will be $75,000 \times 290/365 = 59,589$.

Following the above formula, the weighted average number of shares for calculation of EPS for the year 20X1-20X2 will be as follows:

Sr. No.	Date	Particulars	No of shares	No of days shares were outstanding	Weighted average no of shares
1	1-Apr-20X1	Opening balance of outstanding equity shares	100,000	365	100,000
2	15-Jun-20X1	Issue of equity shares	75,000	290	59,589
3	8-Nov-20X1	Conversion of convertible preference shares in Equity	50,000	144	19,726
4	22-Feb-20X2	Buy back of shares	(20,000)	(38)*	(2,082)
5	31-Mar-20X2	Closing balance of outstanding equity shares	205,000		177,233

- * These shares had already been considered in the shares issued. The same has been deducted assuming that the bought back shares have been extinguished immediately.

Illustration 4

On 31 March, 20X2, the issued share capital of a company consisted of ₹100,000,000 in ordinary shares of ₹25 each and ₹500,000 in 10% cumulative non-redeemable preference shares of Re. 1 each. On 1 October, 20X2, the company issued 1,000,000 ordinary shares fully paid by way of capitalization of reserves in the proportion 1:4 for the year ended 31 March, 20X3.

Profit for 20X1-20X2 and 20X2-20X3 is ₹450,000 and ₹550,000 respectively.

Calculate the basic EPS for 20X1-20X2 and 20X2-20X3.

Solution

	20X2-20X3	20X1-20X2
Calculation of earnings	₹'000	₹'000
Profit for the year	550	450
Less: Preference shares dividend	(50)	(50)
Earnings (A)	500	400

Number of ordinary shares	No. of shares	No. of shares
	in '000	in '000
Shares in issue for full year	4,000	4,000
Capitalization issue at 1 October 20X2	1,000	1,000
Number of shares (B)	5,000	5,000
Earnings per ordinary share (A/B)	10 Paise	8 Paise*

*The comparative EPS for 20X1-20X2 can alternatively be calculated by adjusting the previously disclosed EPS in 20X1-20X2 (in this example, 10 Paise) by the following factor:

Number of shares before the bonus issue/ Number of shares after the bonus issue

*Adjusted EPS for 20X1-20X2 $10 \text{ Paise} \times (4,000 / 5,000) = 8 \text{ Paise}$

Illustration 5

X Ltd.

1 January	1,000,000 shares in issue
28 February	Issued 200,000 shares at fair value
31 August	Bonus issue 1 share for 3 shares held
30 November	Issued 250,000 shares at fair value

Calculate the number of shares which would be used in the basic EPS calculation. Consider reporting date as December end.

Solution

Period	Calculations	Weighted average number of shares
1 January - 28 February	$1,000,000 \times 2 / 12 \times 4 / 3$	222,222
1 March - 31 August	$1,200,000 \times 6 / 12 \times 4 / 3$	800,000
1 September - 30 November	$1,600,000 \times 3 / 12$	400,000
1 December - 31 December	$1,850,000 \times 1 / 12$	154,167
		1,576,389

Illustration 6

At 31 December 20X1, the issued share capital of a company consisted of 1.8 million ordinary shares of ₹10 each, fully paid. The profits for the year ended 31 December 20 X1 and 20X2 amounted to ₹630,000 and ₹875,000 respectively. On 31 March 20X2, the company made a rights issue on a 1 for 4 basis at ₹30. The market price of the shares immediately before the rights issue was ₹60.

Calculate EPS.

Solution

Calculation of theoretical ex rights price:

	No. of Shares		₹

Initial Holding	4	Market Value (4 x 60)	240
Rights taken up	1	Cost (1 x 30)	30
New Holding	5	Theoretical price	270

Theoretical ex rights price = $270/5 = ₹54$

Calculation of bonus element

The bonus element of the rights issue is given by the fraction:

Market price before rights issue/Theoretical ex-rights price = $60 / 54 = 10/9$

This corresponds to a bonus issue of 1 for 9.

The bonus ratio will usually be greater than 1 (that is, the market price of the shares immediately prior to the exercise of rights is greater than the theoretical ex-rights price). If the ratio is less than 1, it might indicate that the market price has fallen significantly during the rights period, which was not anticipated when the rights issue was announced. In this situation, the rights issue should be treated as an issue of shares for cash at full market price.

It can be demonstrated, using the figures in the illustration, that a rights issue of 1 for 4 at ₹ 30 is equivalent to a bonus issue of 1 for 9 combined with an issue of shares at full market price of ₹ 54 per share. Consider an individual shareholder holding 180 shares:

	Number of shares (in '000s)	Value	₹ (In million)
Original holding	1,800	Value at ₹60 per share	108.00
Rights shares (1:4)	450	Value at ₹30 per share	13.50
Holding after rights issue	2,250	Value at ₹54 per share	121.50

The additional 450 thousand rights shares at ₹30 can be shown to be equivalent to a bonus issue of 1 for 9 on the original holding, followed by an issue of 1:8 at full market price of ₹54 following the bonus issue, as follows:

	Number of shares (in '000s)	Value	₹ (In million)
Original holding	1,800	Value at ₹60 per share	108.00
Bonus issue of 1 for 9	200	Value Nil	nil
	2000	Value at ₹ 54 per share	108.00
Issue of 1 for 8 at full price (450-200)	250	Value at ₹ 54 per share	13.50
Total holding	2250	Value at ₹54 per share	121.50

The shareholder is therefore indifferent as to whether the entity makes a rights issue of 1 for 4 at ₹ 30 per share, or a combination of a bonus issue of 1 for 9 followed by a rights issue of 1 for 8 at full market price of ₹ 54 per share.

Having calculated the bonus ratio, the ratio should be applied to adjust the number of shares in issue before the rights issue, both for the current year and for the previous year. Therefore, the weighted average number of shares in issue for the current and the previous period, adjusted for the bonus element, would be:

Weighted average number of shares:

	20X2	20X1
No of actual shares in issue before rights	1,800,000	1,800,000

Correction for bonus issue (1:9)	<u>200,000</u>	<u>200,000</u>
Deemed no of shares in issue before right issue (1.8 million x 10/9 for the whole year)	<u>2,000,000</u>	<u>2,000,000</u>
The no of shares after the rights issue would be= 1.8 million x 5/4 = 2,250,000.		
Therefore, the weighted average number of shares would be		
2.0 million for the whole year	-	2,000,000
1.8 million x 10/9 x 3/12 (before rights issue)	500,000	-
2.25 million x 9/12 (after rights issue)	<u>1,687,500</u>	<u>-</u>
Weighted average number	<u>2,187,500</u>	<u>2,000,000</u>

	20X2	20X1
Calculation of earnings		(as previously stated)
Profits for the year	₹875,000	₹630,000
Weighted average number	2,187,500	1,800,000
Basic EPS	40 Paise	35 Paise
Basic EPS for 20X1 (as restated)		₹630,000 / 2,000,000 = 31.50 paise

In practice, the restated EPS for 20X1 can also be calculated by adjusting the EPS figure of the previous year by the reciprocal of the bonus element factor:

*35 paise x 9/10 = 31.50 paise.

Illustration 7

Entity A has in issue 25,000 4% debentures with a nominal value of Re 1. The debentures are convertible to ordinary shares at a rate of 1:1 at any time until 20X9. The entity's management receives a bonus based on 1% of profit before tax.

Entity A's results for 20X2 showed a profit before tax of ₹80,000 and a profit after tax of ₹64,000 (for simplicity, a tax rate of 20% is assumed in this example).

Calculate Earnings for the purpose of diluted EPS.

Solution

For the purpose of calculating diluted EPS, the earnings should be adjusted for the reduction in the interest charge that would occur if the debentures were converted, and for the increase in the management bonus payment that would arise from the increased profit.

	Amount (₹)
Profit after tax	64,000
Add: Reduction in interest cost (25,000 × 4%) (Refer Note)	1,000
Less: Tax expense (1,000 × 20%)	(200)
Less: Increase in management bonus (1,000 × 1%)	(10)
Add: Tax benefit (10 × 20%)	<u>2</u>
Earnings for the purpose of diluted EPS	<u>64,792</u>

Note : For simplicity, this illustration does not classify the components of the convertible debenture as liabilities and equity, as required by Ind AS 32

Illustration 8 – (MTP – March 2021)

ABC Ltd. has 1,000,000 ₹1 ordinary shares and 1,000 ₹100 10% convertible bonds (issued at par), each convertible into 20 ordinary shares on demand, all of which have been in issue for the whole of the reporting period.

ABC Ltd.'s share price is ₹4.50 per share and earnings for the period are ₹500,000. The tax rate applicable to the entity is 21%.

Calculate basic EPS, earnings per incremental share for the convertible bonds and diluted EPS.

Ignore the requirements of Financial Instruments (Ind AS 109) for the purpose of this question. (4 Marks)

Solution

Basic EPS is ₹0.50 per share (i.e. 500,000/1,000,000)

The earnings per incremental share for the convertible bonds is calculated as follows:

$$\begin{aligned} \text{Earnings effect} &= \text{No. of bonds} \times \text{nominal value} \times \text{interest cost} \times (1 - \text{applicable tax rate}) \\ &= 1,000 \times 100 \times 10\% \times (1 - 0.21) = ₹7,900. \end{aligned}$$

Incremental shares calculation

Assume all bonds are converted to shares, even though this converts ₹100 worth of bonds into 20 shares worth only ₹90 and is therefore not economically rational. This gives $1000 \times 20 = 20,000$ additional shares.

$$\text{Earnings per incremental share} = ₹7,900 / 20,000 = ₹0.395$$

$$\text{Diluted EPS} = (\text{₹500,000} + ₹7,900) / (1,000,000 + 20,000) = ₹0.498 \text{ per share.}$$

Illustration 9 (Past Exam July'21) (MTP May'23)

At 30 June 20X1, the issued share capital of an entity consisted of 1,500,000 ordinary shares of ₹1 each. On 1 October 20X1, the entity issued ₹1,250,000 of 8% convertible loan stock for cash at par. Each ₹100 nominal of the loan stock may be converted, at any time during the years ended 20X6 to 20X9, into the number of ordinary shares set out below:

- 30 June 20X6 : 135 ordinary shares;
- 30 June 20X7 : 130 ordinary shares;
- 30 June 20X8 : 125 ordinary shares; and
- 30 June 20X9 : 120 ordinary shares.

If the loan stocks are not converted by 20X9, they would be redeemed at par.

The written equity conversion option is accounted for as a derivative liability and marked to market through profit or loss. The change in the options' fair value reported in 20X2 and 20X3 amounted to losses of ₹2,500 and ₹2,650 respectively. It is assumed that there are no tax consequences arising from these losses.

The profit before interest, fair value movements and taxation for the year ended 30 June 20X2 and 20X3 amounted to ₹825,000 and ₹895,000 respectively and relate wholly to continuing operations. The rate of tax for both periods is 33%.

Calculate Basic and Diluted EPS for year ended 30th June 20X2 & 30th June 20X3. (8 Marks)

Solution

20X3	20X2
₹	₹

A. Profit before interest, fair value movements and tax	895,000	825,000
B. Interest on 8% convertible loan stock (20X2: 9/12×₹100,000)	(100,000)	(75,000)
C. Change in fair value of embedded option	<u>(2,650)</u>	<u>(2,500)</u>
Profit before tax	<u>792,350</u>	<u>747,500</u>
Taxation @ 33% on (A-B)	<u>(262,350)</u>	<u>(247,500)</u>
Profit after tax	<u>530,000</u>	<u>500,000</u>

Calculation of Basic EPS

Number of equity shares outstanding	1,500,000	1,500,000
Earnings	₹530,000	₹500,000
Basic EPS	35 paise	33 paise

Calculation of Diluted EPS**Test whether convertibles are dilutive:**

The saving in after-tax earnings, resulting from the conversion of ₹100 nominal of loan stock, amounts to $₹100 \times 8\% \times 67\% + ₹2,650/12,500 = ₹5.36 + ₹0.21 = ₹5.57$.

There will then be 135 extra shares in issue.

Therefore, the incremental EPS is 4 paise (i.e. ₹5.57/135). As this incremental EPS is less than the basic EPS at the continuing level, it will have the effect of reducing the basic EPS of 35 paise. Hence the convertibles are dilutive.

	20X3	20X2
	₹	₹
Profit for Basic EPS	530,000	500,000
Add: Interest and other charges on earnings saved	102,650	77,500
as a result of the conversion	(100,000 + 2,650)	(75,000 + 500)
Less: Tax relief thereon	<u>(33,000)</u>	<u>(24,750)</u>
Adjusted earnings for equity	<u>599,650</u>	<u>552,750</u>

Adjusted number of shares

From the conversion terms, it is clear that the maximum number of shares issuable on conversion of ₹1,250,000 loan stock after the end of the financial year would be at the rate of 135 shares per ₹100 nominal (that is, 1,687,500 shares).

	20X3	20X2
Number of equity shares for Basic EPS	1,500,000	1,500,000
Maximum conversion at date of issue (1,687,500 × 9/12)	–	1,265,625
Maximum conversion after balance sheet date	<u>1,687,500</u>	–
Adjusted capital	3,187,500	2,765,625
Adjusted earnings for equity	₹599,650	₹552,750
Diluted EPS (approx.)	19 paise	20 paise

Note: Since Effective Interest Rate is not given, splitting of the convertible loan into liability and equity components as envisaged under Ind AS 109 cannot be done. However, since fair values of derivatives are given, the same is considered for accounting at FVTPL

Illustration 10

At 31 December 20X7 and 20X8, the issued share capital of an entity consisted of 4,000,000 ordinary shares of ₹25 each. The entity has granted options that give holders the right to subscribe for ordinary shares between 20Y6 and 20Y9 at ₹70 per share. Options outstanding at 31 December 20X7 and 20X8 were 630,000. There were no grants, exercises or lapses of options during the year. The profit after tax, attributable to ordinary equity holders for the years ended 31 December 20X7 and 20X8, amounted to ₹500,000 and ₹600,000 respectively (wholly relating to continuing operations).

Average market price of share:

Year ended 31 December 20X7 = ₹120

Year ended 31 December 20X8 = ₹160

Calculate basic and diluted EPS.

Solution**Calculation of basic EPS**

	20X8	20X7
Profit after tax	₹600,000	₹500,000
Number of shares	4,000,000	4,000,000
Basic EPS (approx.)	15 paise	13 paise.

Calculation of Diluted EPS**Adjusted number of shares**

Number of shares under option:

Issued at full market price:

$(630,000 \times 70) \div 120$ 367,500

$(630,000 \times 70) \div 160$ 275,625

Issued at nil consideration — dilutive 354,375 262,500

Total number of shares under option 630,000 630,000

Number of equity shares for basic EPS 4,000,000 4,000,000

Number of dilutive shares under option 354,375 262,500

Adjusted number of shares (A) 4,354,375 4,262,500

Profit after tax (B) ₹600,000 ₹500,000

Diluted EPS (B/A) 14 paise 12 paise

Note: If options had been granted or exercised during the period, the number of 'nil consideration' shares in respect of these options would be included in the diluted EPS calculation on a weighted average basis for the period prior to exercise.

Illustration 11 – (RTP Dec 2021)

Profit attributable to ordinary equity holders of the parent entity for year 20X1	₹ 1,200,000
Weighted average number of ordinary shares outstanding during year 20X1	500,000 shares
Average market price of one ordinary share during year 20X1	₹ 20.00
Weighted average number of shares under option during year 20X1	100,000 shares
Exercise price for shares under option during year 20X1	₹ 15.00
Calculate basic and diluted EPS.	

Solution**Calculation of earnings per share**

	Earnings	Shares	Per share
Profit attributable to ordinary equity holders of the parent entity for year 20X1	1,200,000		
Weighted average shares outstanding during year 20X1		500,000	
Basic earnings per share			2.40
Weighted average number of shares under option		100,000	
Weighted average number of shares that would have been issued at average market price: $(100,000 \times ₹15.00) \div ₹20.00$	Refer Note	(75,000)	(0.11)
Diluted earnings per share	1,200,000	525,000	₹2.29

Note: Earnings have not increased because the total number of shares has increased only by the number of shares (25,000) deemed to have been issued for no consideration.

Illustration 12

Ordinary shares outstanding during 20X1 : 1,000,000 (there were no options, warrants or convertible instruments outstanding during the period)

An agreement related to a recent business combination provides for the issue of additional ordinary shares based on the following conditions

: 5,000 additional ordinary shares for each new retail site opened during 20X1

: 1,000 additional ordinary shares for each ₹1,000 of consolidated profit in excess of ₹2,000,000 for the year ended 31 December 20X1

Retail sites opened during the year : one on 1 May 20X1
one on 1 September 20X1

Consolidated year-to-date profit attributable to ordinary equity holders of the parent entity:

₹1,100,000 as of 31 March 20X1

₹2,300,000 as of 30 June 20X1

₹1,900,000 as of 30 September 20X1 (including a ₹450,000 loss from a discontinued operation)

₹2,900,000 as of 31 December 20X1

Calculate basic and diluted EPS on quarterly as well as annual basis

Solution

Basic earnings per share

	First quarter	Second quarter	Third quarter	Fourth quarter	Full year
Numerator (₹)	1,100,000	1,200,000	(400,000)	1,000,000	2,900,000
Denominator:					
Ordinary shares outstanding	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Retail site contingency	—	3,333 ⁶	6,667 ⁷	10,000	5,000 ⁸
Earnings contingency ⁹	—	—	—	—	—
Total shares	1,000,000	1,003,333	1,006,667	1,010,000	1,005,000
Basic earnings per share (₹)	1.10	1.20	(0.40)	0.99	2.89

⁶ 5,000 shares × 2/3

⁷ 5,000 shares + (5,000 shares × 1/3)

⁸ (5,000 shares × 8/12) + (5,000 shares × 4/12)

⁹ The earnings contingency has no effect on basic earnings per share because it is not certain that the condition is satisfied until the end of the contingency period. The effect is negligible for the fourth-quarter and full-year calculations because it is not certain that the condition is met until the last day of the period.

Diluted earnings per share

	First quarter	Second quarter	Third quarter	Fourth quarter	Full year
Numerator (₹)	1,100,000	1,200,000	(400,000)	1,000,000	2,900,000
Denominator:					
Ordinary shares outstanding	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Retail site contingency	—	5,000	10,000	10,000	10,000
Earnings contingency	— ¹⁰	300,000 ¹¹	— ¹²	900,000 ¹³	900,000
Total shares	1,000,000	1,305,000	1,010,000	1,910,000	1,910,000
Diluted earnings per share (₹)	1.10	0.92	(0.40) ¹⁴	0.52	1.52

¹⁰ Company A does not have year-to-date profit exceeding ₹2,000,000 at 31 March 20X1. The Standard does not permit projecting future earnings levels and including the related contingent shares.

¹¹ [(₹2,300,000 – ₹2,000,000) ÷ 1,000] × 1,000 shares = 300,000 shares.

¹² Year-to-date profit is less than ₹2,000,000.

¹³ [(₹2,900,000 – ₹2,000,000) ÷ 1,000] × 1,000 shares = 900,000 shares.

¹⁴ Because the loss during the third quarter is attributable to a loss from a discontinued operation, the antidilution rules do not apply. The control number (i.e. profit or loss from, continuing operations

attributable to the equity holders of the parent entity) is positive. Accordingly, the effect of potential ordinary shares is included in the calculation of diluted earnings per share.

Illustration 13 (Past Exam Dec'21) (MTP May'24)

Assume the following facts for Company XY:

- Income from continuing operations:	INR 30,00,000
- Loss from discontinued operations:	(INR 36,00,000)
- Net loss:	(INR 6,00,000)
- Weighted average Number of shares outstanding	10,00,000
- Incremental common shares outstanding relating to stock options	2,00,000

- a) You are required to calculate the basic and diluted EPS for Company XY from the above information.
 b) Assume, if in above case, Loss from continued operations is ₹ 10,00,000 and income from discontinued operations is ₹ 36,00,000 calculate the diluted EPS. (8 Marks)

Solution:

(a) Step 1:

Basic EPS = Profit for the year / Weighted average Number of shares outstanding

Basic EPS (Continued Operations) = Profit from continued operations / Weighted average Number of shares outstanding

$$= ₹ 30,00,000 / 10,00,000 = ₹ 3.00$$

Basic Loss per share (Discontinued operations) = Loss from discontinued operations / Weighted average Number of shares outstanding

$$= ₹ (36,00,000) / 10,00,000 = ₹ (3.60)$$

$$\text{Overall Basic Loss per share} = ₹ 6,00,000 / 10,00,000 = ₹ (0.60) \dots\dots\dots(i)$$

Step 2: Calculation of Diluted EPS

Diluted EPS = Profit for the year / Adjusted Weighted average Number of shares outstanding

EPS (Continued Operations) = Profit from continued operations / Adjusted Weighted average Number of shares outstanding

$$= ₹ 30,00,000 / 12,00,000 = ₹ 2.50$$

Loss per share (Discontinued operations) = Loss from discontinued operations / Adjusted weighted average number of shares outstanding

$$= ₹ (36,00,000) / 12,00,000 = ₹ (3.00)$$

$$\text{Overall Diluted Loss per share} = ₹ 6,00,000 / 12,00,000 = ₹ (0.50) \dots\dots\dots(ii)$$

The income from continuing operations is the control number, there is a dilution in basic EPS for income from continuing operations (reduction of EPS from ₹ 3.00 to ₹ 2.50). Therefore, even though there is an anti-dilution [Loss per share reduced from ₹ 0.60 (i) to ₹ 0.50 (ii) above], diluted loss per share of ₹ 0.50 is reported.

- (b) In case of loss from continuing operations, the potential shares are excluded since including those shares would result into anti-dilution effect on the control number (loss from continuing operations). Therefore, the diluted EPS will be calculated as under:

Diluted EPS = Profit for the year / Adjusted weighted average number of shares outstanding
 Overall Profit = Loss from continuing operations + Gain from discontinued operations

$$= ₹ (10,00,000) + ₹ 36,00,000$$

$$= ₹ 26,00,000$$

Weighted average number of shares outstanding = 10,00,000

$$\text{Diluted EPS} = ₹ 2.60$$

The dilutive effect of the potential common shares on EPS for income from discontinued operations and net income would not be reported because of the loss from continuing operations.

Illustration 14 (MTP Oct'20)

An entity issues 2,000 convertible bonds at the beginning of Year 1. The bonds have a three-year term, and are issued at par with a face value of ₹1,000 per bond, giving total proceeds of ₹2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6 percent. Each bond is convertible at any time up to maturity into 250 ordinary shares. The entity has an option to settle the principal amount of the convertible bonds in ordinary shares or in cash.

When the bonds are issued, the prevailing market interest rate for similar debt without a conversion option is 9 percent. At the issue date, the market price of one ordinary share is ₹3. Income tax is ignored. Entity has accounted for the convertible instrument using the principles of Financial Instruments.

Interest @ 6% for the year has already been adjusted in the profit attributable to shareholders

Calculate basic and diluted EPS when

Profit attributable to ordinary equity holders of the parent entity Year 1	₹1,000,000
Ordinary shares outstanding	1,200,000
Convertible bonds outstanding	2,000

(5 Marks)

Solution

Allocation of proceeds of the bond issue:	
Liability component (Refer Note 1)	₹3,03,755
Equity component	₹16,96,245
	₹2,000,000

The liability and equity components would be determined in accordance with IND AS 32. These amounts are recognised as the initial carrying amounts of the liability and equity components. The amount assigned to the issuer conversion option equity element is an addition to equity and is not adjusted.

Basic earnings per share Year 1:

$$\frac{₹1,000,000}{1,200,000} = ₹0.83 \text{ per ordinary share}$$

Diluted earnings per share Year 1:

It is presumed that the issuer will settle the contract by the issue of ordinary shares. The dilutive effect is therefore calculated in accordance with the Standard.

$$\frac{₹1,000,000 + ₹27,338}{1,200,000 + 500,000} = ₹0.60 \text{ per ordinary share}$$

Notes:

1. This represents the present value of the interest discounted at 9% – 120,000 payable annually in arrears for three years. 2,000,000 assumed to be settled in equity since option is with the entity will not form part of liability
2. Profit is adjusted for the accretion of ₹ 27,338 ($₹ 303,755 \times 9\%$) of the liability because of the passage of time
3. 500,000 ordinary shares = 250 ordinary shares $\times$ 2,000 convertible bonds.

Illustration 15

An entity has two classes of shares in issue:

- 5,000 non-convertible preference shares
- 10,000 ordinary shares

The preference shares are entitled to a fixed dividend of ₹5 per share before any dividends are paid on the ordinary shares. Ordinary dividends are then paid in which the preference shareholders do not participate. Each preference share then participates in any additional ordinary dividend above ₹2 at a rate of 50% of any additional dividend payable on an ordinary share.

The entity's profit for the year is ₹100,000, and dividends of ₹2 per share are declared on the ordinary shares.

Compute the allocation of earnings for the purpose of calculation of Basic EPS when an entity has ordinary shares & participating equity instruments that are not convertible into ordinary shares.

Solution

The calculation of basic EPS is as follows:

		₹	₹
Profit			100,000
Less : Dividends payable for the period:			
Preference	(5,000 $\times$ ₹5)	25,000	
Ordinary	(10,000 $\times$ ₹2)	<u>20,000</u>	<u>(45,000)</u>
Undistributed earnings			<u>55,000</u>

Allocation of undistributed earnings:

Allocation per ordinary share = A

Allocation per preference share = B where B = 50% of A

$$(A \times 10,000) + (50\% \times A \times 5,000) = ₹55,000$$

$$A = 55,000 / (10,000 + 2,500) = ₹4.4$$

$$B = 50\% \text{ of } A \text{ i.e. } B = ₹2.2$$

Dividend per share are:	Preference shares ₹per share	Ordinary shares ₹per share
Distributed earnings	5.00	2.00
Undistributed earnings	<u>2.20</u>	<u>4.40</u>
Totals	<u>7.20</u>	<u>6.40</u>

$$\text{Proof: } (5,000 \times ₹7.2) + (10,000 \times ₹6.4) = ₹100,000$$

Illustration 16

(This illustration does not illustrate the classification of the components of convertible financial instruments as liabilities and equity or the classification of related interest and dividends as expenses and equity as required by IND AS 32).

Profit attributable to equity holders of the parent entity	₹100,000
Ordinary shares outstanding	10,000
Non-convertible preference shares	6,000
Non-cumulative annual dividend on preference shares (before any dividend is paid on ordinary shares)	₹5.50 per share
After ordinary shares have been paid a dividend of ₹2.10 per share, the preference shares participate in any additional dividends on a 20:80 ratio with ordinary shares.	

Compute the allocation of earnings for the purpose of calculation of Basic EPS when an entity has ordinary shares & participating equity instruments that are not convertible into ordinary shares.

Solution

Dividends on preference shares paid (6000 x ₹5.50 per share)	₹33,000
Dividends on ordinary shares paid (10,000 x ₹2.10 per share)	₹21,000

Basic earnings per share is calculated as follows:

	₹	₹
Profit attributable to equity holders of the parent entity		100,000
Less: Dividends paid:		
Preference	33,000	
Ordinary	<u>21,000</u>	<u>(54,000)</u>
Undistributed earnings		<u>46,000</u>

Allocation of undistributed earnings:

Allocation per ordinary share = A

Allocation per preference share = B; B = 1/4 A

$$(A \times 10,000) + (1/4 \times A \times 6,000) = ₹46,000$$

$$A = ₹46,000 \div (10,000 + 1,500)$$

$$A = ₹4.00$$

$$B = 1/4 A$$

$$B = ₹1.00$$

Dividend per share:	Preference shares	Ordinary shares
Distributed earnings	₹5.50	₹2.10
Undistributed earnings	<u>₹1.00</u>	<u>₹4.00</u>
Totals	<u>₹6.50</u>	<u>₹6.10</u>

Solution

	Number of shares	Profit ₹
Profit		200,000
Outstanding shares	1,000,000	
New shares on conversion (weighted average)		
($9/12 \times ₹25,000 / 100 \times 120$)	22,500	-
Figures for basic EPS	1,022,500	200,000
Basic EPS is ($₹200,000 / 1,022,500$) = 0.196 per share		
Dilution adjustments		
<u>Unconverted shares :</u> ($₹75,000 / 100 \times 120$)	90,000	
Interest : ($₹75,000 \times 5\% \times 0.7$)		2,625
<u>Converted shares pre conversion adjustment</u>		
$3/12 \times ₹ 25,000 / 100 \times 120$	7,500	
Interest : [$3/12 \times ₹25,000 \times 5\% \times 0.7$]		219
	<u>1,120,000</u>	<u>202,844</u>

Diluted EPS is ($₹ 202,844 / 1,120,000$) = 0.181

Illustration 20

1 January	Shares in issue	1,000,000
	Profit for the year ended 31 December	₹100,000
	Average fair value during period	₹8

The company has in issue 200,000 options to purchase equal ordinary shares

Exercise price ₹6

Calculate the diluted EPS for the period.

Solution**Diluted EPS**

	Number of Shares	Profit (₹)	EPS
Basic	1,000,000	100,000	0.10
Dilution (Refer W.N.)	50,000	-	-
	<u>1,050,000</u>	<u>100,000</u>	<u>0.095</u>

Working Notes:

Proceeds of issue	($200,000 \times ₹6$)	=	1,200,000
Number that would have been issued at Fair value ($1,200,000 / ₹8$)	=		150,000
Number actually issued			<u>200,000</u>
Number for "free" ($200,000 - 150,000$)			<u>50,000</u>

Illustration 21

Calculate EPS, when

	20X0	20X1	20X2
Profit attributable to ordinary equity holders of the parent entity	₹1,100	₹1,500	₹1,800

Shares outstanding before rights issue	500 shares
Rights issue	One new share for each five outstanding shares
Exercise price	₹5.00
Date of rights issue	1 January 20X1
Last date to exercise rights	1 March 20X1
Market price of one ordinary share immediately before exercise on 1 March 20X1:	₹11.00
Reporting date	31 December

Solution**Calculation of theoretical ex-rights value per share**

Fair value of all outstanding shares before the exercise of rights + total amount received from exercise of rights

Number of shares outstanding before exercise + number of shares issued in the exercise

$$= \frac{(\text{₹}11.00 \times 500 \text{ shares}) + (\text{₹}5.00 \times 100 \text{ shares})}{500 \text{ shares} + 100 \text{ shares}}$$

$$= \frac{\text{₹}6,050}{600 \text{ shares}} = \text{₹}10.08$$

Theoretical ex-rights value per share = ₹10.00

Calculation of adjustment factor

$$\frac{\text{Fair value per share before exercise of rights}}{\text{Theoretical ex-rights value per share}} = \frac{\text{₹}11.00}{\text{₹}10.00} = 1.10$$

$$\text{Theoretical ex-rights value per share} = \text{₹}10.00$$

Calculation of basic earnings per share

	20X0	20X1	20X2
20X0 Basic EPS as originally reported : ₹1,100 / 500 shares	₹2.20		
20X0 Basic EPS restated for rights : ₹1,100 / (500 shares x 1.1)	₹2.00		
20X1 Basic EPS including effects of rights issue : {₹1,500 / [(500 x 1.1 x 2/12) + (600x10/12)]}		₹2.54	
20X2 Basic EPS: ₹1,800 / 600 shares			₹3.00

Illustration 22

Calculate Subsidiary's and Group's Basic EPS and Diluted EPS, when

Parent:	
Profit attributable to ordinary equity holders of the parent entity	₹12,000 (excluding any earnings of, or dividends paid by, the subsidiary)
Ordinary shares outstanding	10,000
Instruments of subsidiary owned by the parent	800 ordinary shares
	30 warrants exercisable to purchase ordinary shares of subsidiary
	300 convertible preference shares
Subsidiary:	
Profit	₹5,400
Ordinary shares outstanding	1,000
Warrants	150, exercisable to purchase ordinary shares of the subsidiary
Exercise price	₹10
Average market price of one ordinary share	₹20
Convertible preference shares	400, each convertible into one ordinary share
Dividends on preference shares	Re. 1 per share
No inter-company eliminations or adjustments were necessary except for dividends.	
Ignore income taxes. Also, ignore classification of the components of convertible financial instruments as liabilities and equity or the classification of related interest and dividends as expenses and equity as required by IND AS 32.	

Solution**Subsidiary's earnings per share**

Basic EPS	₹5.00 calculated :	$\frac{₹5,400 (a) - ₹400 (b)}{1,000 (c)}$
Diluted EPS	₹3.66 calculated :	$\frac{₹5,400 (d)}{(1,000 + 75 (e) + 400(f))}$

Notes:

- (a) Subsidiary's profit attributable to ordinary equity holders.
- (b) Dividends paid by subsidiary on convertible preference shares.
- (c) Subsidiary's ordinary shares outstanding.
- (d) Subsidiary's profit attributable to ordinary equity holders (₹5,000) increased by ₹400 preference dividends for the purpose of calculating diluted earnings per share.
- (e) Incremental shares from warrants, calculated: $[(₹20 - ₹10) \div ₹20] \times 150$.

- (f) Subsidiary's ordinary shares assumed outstanding from conversion of convertible preference shares, calculated: $400 \text{ convertible preference shares} \times \text{conversion factor of } 1$.

Consolidated earnings per share

Basic EPS ₹1.63 calculated : $\frac{\text{₹12,000(a)} + \text{₹4,300(b)}}{10,000(c)}$

Diluted EPS ₹1.61 calculated : $\frac{\text{₹12,000} + \text{₹2,928(d)} + \text{₹55(e)} + \text{₹1,098(f)}}{10,000}$

- (a) Parent's profit attributable to ordinary equity holders of the parent entity.
- (b) Portion of subsidiary's profit to be included in consolidated basic earnings per share, calculated: $(800 \times \text{₹5.00}) + (300 \times \text{Re. } 1.00)$.
- (c) Parent's ordinary shares outstanding.
- (d) Parent's proportionate interest in subsidiary's earnings attributable to ordinary shares, calculated: $(800 \div 1,000) \times (1,000 \text{ shares} \times \text{₹3.66 per share})$.
- (e) Parent's proportionate interest in subsidiary's earnings attributable to warrants, calculated: $(30 \div 150) \times (75 \text{ incremental shares} \times \text{₹3.66 per share})$.
- (f) Parent's proportionate interest in subsidiary's earnings attributable to convertible preference shares, calculated: $(300 \div 400) \times (400 \text{ shares from conversion} \times \text{₹3.66 per share})$.

Illustration 23 - (RTP May'20) (MTP April'21) (Past Exam Nov'22)

CAB Limited is in the process of preparation of the consolidated financial statements of the group for the year ending 31st March, 20X3 and the extract of the same is as follows:

Particulars	Attributable to CAB Limited	Non-controlling interest	Total (₹ in 000)
Profit for the year	39,000	3,000	42,000
Other Comprehensive Income	5,000	Nil	5,000
Total Comprehensive Income	44,000	3,000	47,000

The long-term finance of the company comprises of the following:

- (i) 20,00,00,000 equity shares at the beginning of the year and the company has issued 5,00,00,000 shares on 1st July, 20X2 at full market value.
- (ii) 8,00,00,000 irredeemable preference shares. These shares were in issue for the whole of the year ended 31st March, 20X3. The dividend on these preference shares is discretionary.
- (iii) ₹ 18 crores of 6% convertible debentures issued on 1st April, 20X1 and repayable on 31st March, 20X5 at par. Interest is payable annually. As an alternative to repayment at par, the holder on maturity can elect to exchange their convertible debentures for 10 crores ordinary shares in the company. On 1st April, 20X1, the prevailing market interest rate for four-year convertible debentures which had no right of conversion was 8%. Using an annual discount rate of 8%, the present value of ₹ 1 payable in four years is 0.74 and the cumulative present value of ₹ 1 payable at the end of years one to four is 3.31.

In the year ended 31st March, 20X3, CAB Limited declared an ordinary dividend of 0.10 paise per share and a dividend of 0.05 paise per share on the irredeemable preference shares.

Compute the following:

- the finance cost of convertible debentures and its closing balance as on 31st March, 20X3 to be presented in the consolidated financial statements.

- the basic and diluted earnings per share for the year ended 31st March, 20X3. Assume that income tax is applicable to CAB Limited and its subsidiaries at 25%. (8 Marks)

Solution:**Calculation of the liability and equity components on 6% Convertible debentures:**

Present value of principal payable at the end of 4th year ($\text{₹ } 1,80,000 \text{ thousand} \times 0.74$) = ₹ 1,33,200 thousand

Present value of interest payable annually for 4 years ($\text{₹ } 1,80,000 \text{ thousand} \times 6\% \times 3.31$) = ₹ 35,748 thousand

Total liability component = ₹ 1,68,948 thousand

Therefore, equity component = ₹ 1,80,000 thousand – ₹ 1,68,948 thousand = ₹ 11,052 thousand

Calculation of finance cost and closing balance of 6% convertible debentures

Year	Opening balance ₹ in '000	Finance cost @ 8% ₹ in '000	Interest paid @ 6% ₹ in '000	Closing balance ₹ in '000
	a	b = a x 8%	c	d = a + b - c
31.3.20X2	1,68,948	13,515.84	10,800	1,71,663.84
31.3.20X3	1,71,663.84	13,733.11	10,800	1,74,596.95

Finance cost of convertible debentures for the year ended 31.3. 20X3 is ₹ 13,733.11 thousand and closing balance as on 31.3. 20X3 is ₹ 1,74,596.95 thousand.

Calculation of Basic EPS

₹ in '000

Profit for the year	39,000
Less: Dividend on preference shares (80,000 thousand x ₹ 0.05)	(4,000)
Profit attributable to equity shareholders	35,000

Weighted average number of shares = $20,00,00,000 + \{5,00,00,000 \times (9/12)\} = 23,75,00,000$

shares or 2,37,500 thousand shares

Basic EPS = ₹ 35,000 thousand / 2,37,500 thousand shares = ₹ 0.147

Calculation of Diluted EPS

₹ in '000

Profit for the year	39,000
Less: Dividend on preference shares (80,000 x 0.05)	(4,000)
	35,000
Add: Finance cost (as given in the above table)	13,733.11
Less: Tax @ 25%	(3,433.28)
	10,299.83
	45,299.83

Weighted average number of shares

$$= 20,00,00,000 + \{5,00,00,000 \times (9/12)\} + 10,00,00,000$$

$$= 33,75,00,000 \text{ shares or } 3,37,500 \text{ thousand shares}$$

Diluted EPS = ₹ 45,299.83 thousand / 3,37,500 thousand shares

$$= ₹ 0.134$$

Question 1 (MTP Oct'19)

Mittal Motors Limited is preparing financials for the year ended March 31, 20 X2. The Company had some queries in preparation of certain data that is required to be presented in the financials. As the retainer of the Company, please advise the company for the following issues:

(i) Mittal Motors has issued 10,00,000 numbers of 9% cumulative preference shares. The Company has arrears of Rs. 15 crores of preference dividend as on March 31, 20X2, it includes current year arrears of Rs. 1.75 crores. The Company did not declare any dividend for equity shareholders as well as for preference shareholders.

What is the amount of dividend to be reduced from profit or loss for the year for calculating basic Earnings Per Share?

(ii) Further Mittal Motors has also issued certain convertible debentures, which are outstanding as at the year end. For the purpose of computation of weighted average number of shares (to arrive at diluted EPS) when should the dilutive potential shares should be deemed to have been converted into shares?

(A) At the start of the period.

(B) The date of issue of the potential shares

(C) At the start of the period or, if later, the date of the issue of the potential shares

(D) At the end of the period

Solution

(i) As per para 14 (b) of Ind AS 33 "Earnings per share", "The after-tax amount of preference dividends that is deducted from profit or loss is the after-tax amount of the preference dividends for cumulative preference shares required for the period, whether or not the dividends have been declared. The amount of preference dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods".

In the given case, the amount of preference dividends Rs.1.75 crores declared for the year ended March 31, 20X2 (i.e., the current period) is to be deducted from profit or loss for calculating EPS.

(ii) As per para 36 of Ind AS 33 "Earnings per share", "For the purpose of calculating diluted earnings per share, the number of ordinary shares shall be the weighted average number of ordinary shares plus the weighted average number of ordinary shares that would be issued on the conversion of all the dilutive potential ordinary shares into ordinary shares. Dilutive potential ordinary shares shall be deemed to have been converted into ordinary shares at the beginning of the period or, if later, the date of the issue of the potential ordinary shares".

Question 2 - (RTP May'18)

P Ltd. is a subsidiary company of ABC Ltd. It preparing both Separate financial statement (SFS) and consolidated financial statements (CFS) for the year ending on 31st March, 20XI. It has net profit after tax of ₹20,00,000 as per SFS & ₹16,00,000 as per CFS. Share capital of P Ltd. is 2,00,000 shares of ₹ 10 each. ABC Ltd. has acquired 80% shares of P Ltd. Accountant of P Ltd. had calculated following Basic EPS for its SFS:

Calculation of Basic EPS in its SFS	
Net Profit after tax	₹ 16,00,000
Number of equity shares attributable to Parent company ABC Ltd. (2,00,000 x 80%)	1,60,000 shares
Basic EPS	₹ 10 per share

Examine the correctness of the above presentation of Basic EPS.

Solution

As per paragraph 4 of Ind AS 33 "Earnings per Share", when an entity presents both consolidated financial statements and separate financial statements prepared in accordance with Ind AS 110, Consolidated Financial Statements, and Ind AS 27, Separate Financial Statements, respectively, the disclosures required by this Standard shall be presented both in the consolidated financial statements and separate financial statements. In consolidated financial statements such disclosures shall be based on consolidated information and in separate financial statements such disclosures shall be based on information given in separate financial statements. An entity shall not present in consolidated financial statements, earnings per share based on the information given in separate financial statements and shall not present in separate financial statements, earnings per share based on the information given in consolidated financial statements.

Also paragraph 9 of the standard states that an entity shall calculate basic earnings per share amounts for profit or loss attributable to ordinary equity holders of the parent entity and, if presented, profit or loss from continuing operations attributable to those equity holders.

Further, paragraph A1 of Appendix A of Ind AS 33 states that for the purpose of calculating earnings per share based on the consolidated financial statements, profit or loss attributable to the parent entity refers to profit or loss of the consolidated entity after adjusting for non-controlling interests.

Therefore, the requirements of paragraph 9 of Ind AS 33 have been provided in the context of calculating EPS in the consolidated financial statements of an entity.

The accountants of P Ltd. had followed this for calculation of Basic EPS in its SFS. As per ITFG Bulletin 11, for SFS analogy may be drawn from paragraph 9 of Ind AS 33 that in case of separate financial statements, the parent entity mentioned in paragraph 9 will imply the legal entity of which separate financial statements are being prepared and accordingly, when an entity presents EPS in its separate financial statements, then the same shall be calculated based on the profit or loss attributable to its equity shareholders.

Hence, the presentation of Basic EPS by the Accountant of P Ltd. on the basis of consolidated financial statements in its separate financial statements is not correct. The correct presentation of Basic EPS would be as follows:

Calculation of Basic EPS of P Ltd. in SFS	
Net Profit after tax	₹ 20,00,000
No. of share issued	2,00,000 shares
Basic EPS	₹ 10 per share

Question 3 – (Past Exam Nov'20) (MTP March'22)

The following information is available relating to Space India Limited for the Financial Year 2019-2020.

Net profit attributable to equity shareholders	₹ 90,000
Number of equity shares outstanding	16,000
Average fair value of one equity share during the year	₹ 90

Potential Ordinary Shares:

Options	900 options with exercise price of ₹ 75
Convertible Preference Shares	7,500 shares entitled to a cumulative dividend of ₹ 9 per share. Each preference share is convertible into 2 equity shares.
Applicable corporate dividend tax	8%
10% Convertible Debentures of ₹ 100 each	₹ 10,00,000 and each debenture is convertible into 4 equity shares
Tax rate	25%

You are required to compute Basic and Diluted EPS of the company for the Financial Year 2019-2020.

(8 Marks)

Solution:

(i) Basic Earnings per share

		Year ended 31.3.2020
Net profit attributable to equity shareholders	(A)	₹ 90,000
Number of equity shares outstanding	(B)	16,000
Earnings per share	(A/B)	₹ 5.625

(ii) Diluted earnings per share

Options are most dilutive as their earnings per incremental share is nil. Hence, for the purpose of computation of diluted earnings per share, options will be considered first. 10% convertible debentures being second most dilutive will be considered next and thereafter convertible preference shares will be considered (as per W.N.).

	Net profit attributable to equity shareholders ₹	No. of equity shares	Net Profit attributable per share ₹	
Net profit attributable to equity shareholders	90,000	16,000	5.625	
Options	<u>90,000</u>	<u>150</u>		
10% Convertible debentures	<u>75,000</u>	<u>40,000</u>	5.572	Dilutive
	1,65,000	56,150	2.939	Dilutive
Convertible Preference Shares	<u>72,900</u>	<u>15,000</u>		
	<u>2,37,900</u>	<u>71,150</u>	3.344	Anti-Dilutive

Since diluted earnings per share is increased when taking the convertible preference shares into account (₹ 2.939 to ₹ 3.344), the convertible preference shares are anti-dilutive and are ignored in the calculation of diluted earnings per share for the year ended 31 March 2020. Therefore, diluted earnings per share for the year ended 31 March 2020 is ₹ 2.939.

Working Note:

Calculation of Incremental earnings per share and allocation of rank

	Increase in earnings (1)	Increase in number of equity shares (2)	Earnings per incremental share (3) = (1) + (2)	Rank
Options	₹		₹	
Increase in earnings	Nil			
No. of incremental shares issued for no consideration [900 x (90-75)/90]		150	Nil	1

Convertible Preference Shares Increase in net profit attributable to equity shareholders as adjusted by attributable dividend tax $[(₹ 9 \times 7,500) + 8\% (₹ 9 \times 7,500)]$ No. of incremental shares $(2 \times 7,500)$	72,900			
10% Convertible Debentures Increase in net profit $[(₹ 10,00,000 \times 10\% \times (1 - 0.25))]$ No. of incremental shares $(10,000 \times 4)$	75,000	15,000	4.86	3
		40,000	1.875	2

Note: Grossing up of preference share dividend has been ignored here. At present dividend distribution tax has been abolished. However, the question has been solved on the basis of the information given in the question.

Question 4 (MTP Oct'21)

Sohan has been recently hired in Zio Life Limited. Since he is facing difficulty in computation of EPS as per Ind AS 33, guide him by discussing the steps for the calculation of Basic EPS and Diluted EPS along with the necessary computations for EPS of Year 1.

The following basic facts relate to Company Zio Life Limited.

- Net profit for Year 1 is ₹ 46,00,000.
- The number of ordinary shares outstanding on 1st April Year 1 is 30,00,000. The following facts are also relevant for Year 1.
- On 1st April, Zio Life Limited issues 20,00,000 three-year term convertible bonds for ₹ 1 each.
- Zio Life Limited has an option to settle the principal amount in ordinary shares (every 10 bonds are convertible into one ordinary share) or cash on settlement date.
- The principal amount of the bonds is classified as an equity instrument and the interest is classified as a financial liability.
- The interest expense relating to the liability component of the bonds is ₹ 1,800.
- The interest expense is tax-deductible. The applicable income tax rate is 40%. (7 Marks)

Solution

(b) The EPS computations for Year 1 as per Ind AS 33 are as follows.

Basic EPS	Diluted EPS
1. Determine the numerator No adjustment is necessary until the convertible bonds are converted and ordinary shares are issued. The numerator is net profit i.e. ₹ 46,00,000.	1. Identify Potential Ordinary Shares (POSSs) The convertible bonds are the only POSSs.

2. Determine the denominator There is no change in the number of outstanding shares during the year. The denominator is therefore 30,00,000.	2. For each POS, calculate Earnings per Incremental Share (EPIS) Since Zio Life Limited has the choice of settlement, for the purpose of determining the EPIS, it assumes the share-settlement assumption. Potential adjustment to the numerator for EPIS: The convertible bonds, when settled in ordinary shares, would increase profit or loss for the year by the post-tax amount of the interest expense: (Interest expense on the convertible bonds) x (1 - income tax rate) = (₹ 1,800) x (1 - 40%) = ₹ 1,080 Potential adjustment to the denominator for EPIS: The convertible bonds, when settled in ordinary shares, would increase the number of outstanding shares by 2,00,000 (20,00,000 / 10). EPIS is calculated as follows: EPIS = 1,080 / 2,00,000 = 0.01
3. Determine basic EPS Basic EPS = 46,00,000 / 30,00,000 = 1.53	3. Rank the POSs This step does not apply, because the convertible bonds are the only class of POSs.
4. Identify dilutive POSs and determine diluted EPS The potential impact of convertible bonds is determined as follows. (Refer W.N. below)	Accordingly, Zio Life Limited includes the impact of the convertible bonds in diluted EPS. Diluted EPS = ₹ 1.44

Working Note:**Calculation of Diluted EPS**

	Earnings (₹)	Weighted average number of shares	Per Share (₹)	Dilutive?
Basic EPS	46,00,000	30,00,000	1.53	
Convertible bonds	1,080	2,00,000		
Total	46,01,080	32,00,000	1.44	Yes

Question 5 (RTP Nov'22)

Company S is a subsidiary of Company P. Following facts are in respect of Company S:

- Company S has 10,000 ordinary shares and 1,000 options outstanding, of which Company P owns 9,000 shares and 500 options, respectively.
- The options have an exercise price of ₹ 40.
- The average market price of Company S's ordinary share was ₹ 50 in 20X1.
- In 20X1, Company S's profit was ₹ 30,000.

Following facts are in respect of Company P:

- Company P has 5,000 ordinary shares outstanding.

- In 20X1, Company P's profit (excluding any distributed and undistributed earnings of subsidiaries) was ₹ 7,000.
- The options outstanding are dilutive at P's level.

Determine the diluted EPS of Company P for the year 20X1. Ignore income tax.

Solution:

To determine the diluted EPS of Company P, the diluted EPS of Company S has to be calculated first.

Calculation of Company S's diluted EPS:

Company S's earnings for the period	₹ 30,000
Weighted average ordinary shares	10,000
Incremental shares (refer W.N.)	200
Company S's diluted EPS	₹ 30,000 / (10,000 + 200)
	₹ 2.94

Calculation of Company P's diluted EPS:

Company P's earning for the period	₹ 7,000
Company P's share of Company S's earning attributable to ordinary shares	₹ 26,460
[(9,000 / 10,000) × (2.94 × 10,000)]	
Company P's share of Company S's earning attributable to options	₹ 294
[(500 / 1,000) × (2.94 × 200)]	
Company P's weighted average ordinary shares outstanding	5,000
Company P's diluted EPS = (7,000 + 26,460 + 294) / 5,000	₹ 6.75

Working Note:

Computation of Incremental shares related to weighted average options outstanding:

All options are dilutive because their exercise price is below the average market price of Company S's ordinary shares for the period.

The incremental shares are calculated as follows:

Shares issued on assumed exercise of options	1,000
Less: Shares that would be issued at average market Price [(40 × 1,000)/50]	(800)
Incremental shares	200

Question 6 (RTP May 23)

Company P has both ordinary shares and equity-classified preference shares in issue.

The reconciliation of the number of shares during Year 1 is set out below:

Dates in Year 1	Transaction	Ordinary shares	Treasury shares	Preference shares
1st April	Balance	30,00,000	(5,00,000)	5,00,000
15th April	Bonus issue – 5% (no corresponding changes in resources)	1,50,000	(25,000)	-
1st May	Repurchase of shares for cash	-	(2,00,000)	-
1st November	Shares issued for cash	4,00,000	-	-
31st March	Balance	35,50,000	(7,25,000)	5,00,000

The following additional information is relevant for Year 1.

- Company P's net profit for the year is ₹ 46,00,000.
- On 15th February, non-cumulative preference dividends of ₹ 1.20 per share were declared. The dividends were paid on 15th March. Preference shares do not participate in additional dividends with ordinary shares.
- Dividends on non-cumulative preference shares are deductible for tax purposes.

The applicable income tax rate is 30%.

The financial year of Company P ends on 31st March.

Determine the Basic EPS of the Company P for Year 1. Use the number of months or part of months, rather than the number of days in the calculation of EPS.

Solution:

Determination of numerator for calculation of Basic EPS

The first step in the basic EPS calculation is to determine the profit or loss that is attributable to ordinary shareholders of Company P for the period.

Non-cumulative dividends paid on equity-classified preference shares are not deducted in arriving at net profit or loss for the period, but they are not returns to ordinary shareholders. Accordingly, these dividends are deducted from net profit or loss for the period in arriving at the numerator.

		(₹)
Net profit		46,00,000
Preference dividends (5,00,000 shares x 1.2)	(6,00,000)	
Related tax (₹ 6,00,000 x 30%)	<u>1,80,000</u>	<u>(4,20,000)</u>
Profit or loss attributable to P's ordinary shareholders		<u>41,80,000</u>
Accordingly, the numerator for calculation of Basic EPS is ₹ 41,80,000		

Determination of denominator for calculation of Basic EPS

The second step in the basic EPS calculation is to determine the weighted-average number of ordinary shares outstanding for the reporting period.

Number of shares	Time weighting	Weight	Weighted average number of shares
1st April – opening balance (30,00,000 – 5,00,000)	25,00,000	1	
15th April – bonus issue (1,50,000 – 25,000)	1,25,000		
1st April to 30th April	26,25,000	1/12	2,18,750
1st May – repurchase of shares	(2,00,000)		
1st May to 31st October	24,25,000	6/12	12,12,500
1st November – new shares issued	4,00,000		
1st November to 31st March	28,25,000	5/12	11,77,083
Weighted average number of shares for the year			26,08,333

The denominator for calculation of Basic EPS is 26,08,333 shares.

Basic EPS = ₹ 41,80,000 / 26,08,333 shares = ₹ 1.60 per share (approx.).

IND AS 34 – INTERIM FINANCIAL REPORTING

Illustration 1

Company A has reported Rs. 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 × 3)]

Expected tax as per slabs = 15,000 × 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)

Illustration 2

ABC Ltd. presents interim financial report quarterly. On 1.4.20X1, ABC Ltd. has carried forward loss of ₹ 600 lakhs for income-tax purpose for which deferred tax asset has not been recognized. ABC Ltd. earns ₹ 900 lakhs in each quarter ending on 30.6.20X1, 30.9.20X1, 31.12.20X1 and 31.3.20X2 excluding the carried forward loss. Income-tax rate is expected to be 40%. Calculate the amount of tax expense to be reported in each quarter.

Solution:

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

The estimated payment of the annual tax on earnings for the current year:

₹ 3,000* × 40 / 100 = ₹ 1,200 lakhs.

*(3,600 lakhs - ₹ 600 lakhs) = ₹ 3,000 lakhs

Average annual effective tax rate = (1,200 / 3,600) × 100 = 33.33%

Tax expense to be shown in each quarter = 900 × 33.33% = ₹ 300 lakhs

Illustration 3

Innovative Corporation Private Limited (or "ICPL") is dealing in seasonal product and the sales pattern of the product, quarter wise is as under during the financial year 20X1-20X2:

Qtr. I	Qtr. II	Qtr. III	Qtr. IV
ending 30 June	ending 30 September	ending 31 December	ending 31 March
10%	10%	60%	20%

For the first quarter ending on 30 June, 20X1, ICPL has provided the following information :

Particulars	Amounts (in crore)
Sales	70
Employees benefits expenses	25
Administrative and other expenses	12
Finance cost	4

ICPL while preparing interim financial report for first quarter wants to defer ₹ 16 crores expenditure to third quarter on the argument that third quarter is having more sales therefore third quarter should be debited by more expenditure. Considering the seasonal nature of business and that the expenditures are uniform throughout all quarters

Calculate the result of first quarter as per Ind AS 34 and comment on the company's view.

Solution:

Result of the first quarter ending 30 June

Particulars	Amounts (in crore)
Sales	70
Total Revenue (A)	70
Less: Employees benefits expenses	(25)
Administrative and other expenses	(12)
Finance cost	(4)
Total Expense (B)	(41)
Profit (A-B)	29

Note- As per Ind AS 34, the income and expense should be recognized when they are earned and incurred respectively. Seasonal incomes will be recognized when they occur. Therefore, the argument of ICPL is not correct considering the principles of Ind AS 34.

Illustration 4 – (Past Exam – July 2021)

Fixed production overheads for the financial year is ₹ 10,000. Normal expected production for the year, after considering planned maintenance and normal breakdown, also considering the future demand of the product is 2,000 MT. It is considered that there are no quarterly / seasonal variations. Therefore, the normal expected production for each quarter is 500 MT and the fixed production overheads for the quarter are ₹ 2,500.

Actual production achieved	Quantity (In MT)
First quarter	400
Second quarter	600
Third quarter	500
Fourth quarter	400
Total	1,900

Presuming that there are no quarterly / seasonal variation, calculate the allocation of fixed production overheads for all the four quarters as per Ind AS 34 read with Ind AS 2. Will the quarterly results affect annual result? **(5 Marks)**

Solution:

If it is considered that there is no quarterly / seasonal variation, therefore normal expected production for each quarter is 500 MT and fixed production overheads for the quarter are ₹ 2,500 .

Fixed production overhead to be allocated per unit of production in every quarter will be ₹ 5 per MT (Fixed overheads / Normal production).

Quarters	Allocations
First Quarter	➤ Actual fixed production overheads = ₹ 2,500 ➤ Fixed production overheads based on the allocation rate of ₹ 5 per unit allocated to actual production = ₹ 5 x 400 = ₹ 2,000 ➤ Unallocated fixed production overheads to be charged as expense as per Ind AS 2 and consequently as per Ind AS 34 = ₹ 500
Second Quarter	➤ Actual fixed production overheads on year-to-date basis = ₹ 5,000 ➤ Fixed production overheads to be absorbed on year-to-date basis = 1,000 x ₹ 5 = ₹ 5,000 ➤ Earlier, ₹ 500 was not allocated to production in the 1st quarter. To give effect to the entire ₹ 5,000 to be allocated in the second quarter, as per Ind AS 34, ₹ 500 are reversed by way of a credit to the statement of profit and loss of the 2nd quarter and debit to cost of production
Third Quarter	➤ Actual production overheads on year-to-date basis = ₹ 7,500 ➤ Fixed production overheads to be allocated on year-to-date basis = 1,500 x 5 = ₹ 7,500 ➤ There is no under or over recovery of allocated overheads. Hence, no further action is required.
Fourth Quarter	➤ Actual fixed production overheads on year-to-date basis = ₹ 10,000 ➤ Fixed production overheads to be allocated on year-to-date basis 1,900 x 5 = ₹ 9,500 ➤ ₹ 500, i.e., [₹ 2,500 – (₹ 5 x 400)] unallocated fixed production overheads in the 4th quarter, are to be expensed off as per the principles of Ind AS 2 and Ind AS 34 by way of a charge to the statement of profit and loss. ➤ Unallocated productions overheads for the year ₹ 500 (i.e ₹ 10,000 – ₹ 9,500) are expensed in the Statement of profit and loss as per Ind AS 2.

The cumulative result of all the quarters would also result in unallocated overheads of ₹ 500, thus, meeting the requirements of Ind AS 34 that the quarterly results should not affect the measurement of the annual results.

Illustration 5 – (MTP – April, 2021) (Past Exam - Dec 2021)

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:

- Bad debts of ₹ 1,00,000 incurred during the quarter. 50% of the bad debts have been deferred to the next quarter.
- Additional depreciation of ₹ 4,50,000 resulting from the change in the method of depreciation.
- Exceptional loss of ₹ 28,000 incurred during the third quarter. 50% of exceptional loss have been deferred to next quarter.
- ₹ 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 (4 Marks)

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 inter 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) Treatment of exceptional loss is not as per the principles of Ind AS 34, as the entire amount of ₹ 28,000 incurred during the third quarter should be recognized in the same quarter. Hence ₹ 14,000 which was deferred should be deducted from the profits of third quarter only.
- iv) 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:
 - a) it is appropriate to anticipate or defer that type of cost at the end of the financial year, and
 - b) 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 ₹ 14,36,000 (₹ 20,00,000 - ₹ 50,000 - ₹ 14,000 - ₹ 5,00,000).

Illustration 6 (MTP April'22)

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. (4 Marks)

Solution

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

Expected Total Income = $15,000 \times 4 = ₹ 60,000$					
Expected Tax as per slabs = $20,000 \times 20\% + 40,000 \times 40\% = ₹20,000$					
Average Annual Income tax rate = $20,000/60,000 \times 100 = 33.33\%$					
					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	

Illustration 7 – (Past Exam Nov'20, MTP Oct'21) – 6 Marks

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 = ₹ 33,00,000 (inclusive of Estimated Capital Gains of ₹ 8,00,000)

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%

Solution:

As per 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.

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:	1,50,000
30% on ₹ 5,00,000	8,00,000
40% on remaining ₹ 20,00,000	9,50,000
(B)	
Weighted average annual income tax rate = $B \div A = 9,50,000 \div 25,00,000 = 38\%$	

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

Illustration 8

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

Solution:

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. Since the effective tax rate or average annual income tax rate is already given in the question as 30%, the income tax expense will be recognised in each interim quarter based on this rate only.

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

Illustration 9

Due to decline in market price in second quarter, Happy India Ltd. incurred an inventory loss. The Market price is expected to return to previous levels by the end of the year. At the end of year, the decline had not reversed. When should the loss be reported in interim statement of profit and loss of Happy India Ltd.?

Solution:

Loss should be recognised in the second quarter of the year.

Illustration 10 (RTP Nov'20, MTP May'24)

An entity's accounting year ends is 31st December, but its tax year end is 31st March. The entity publishes an interim financial report for each quarter of the year ended 31st December, 2019. The entity's profit before tax is steady at ₹10,000 each quarter, and the estimated effective tax rate is 25% for the year ended 31st March, 2019 and 30% for the year ended 31st March, 2020.

How the related tax charge would be calculated for the year 2019 and its quarters.

(4 Marks)

Solution

Table showing computation of tax charge:

	Quarter ending 31st March, 2019	Quarter ending 30th June, 2019	Quarter ending 30th Sept, 2019	Quarter ending 31st Dec, 2019	Year ending 31st Dec, 2019
	₹	₹	₹	₹	₹
Profit before tax	10,000	10,000	10,000	10,000	40,000
Tax charge	(2,500)	(3,000)	(3,000)	(3,000)	(11,500)
	7,500	7,000	7,000	7,000	28,500

Since an entity's accounting year is not same as the tax year, more than one tax rate might apply during the accounting year. Accordingly, the entity should apply the effective tax rate for each interim period to the pre-tax result for that period.

Illustration 11 (RTP May'23)

The entity's financial year ends on 31st March. What are the "reporting periods" for which financial statements (condensed or complete) in the interim financial report of the entity as on 30th September, 20X1 are required to be presented, if:

- Entity publishes interim financial reports quarterly
- Entity publishes interim financial reports half-yearly.

Solution:

Paragraph 20 of Ind AS 34, Interim Financial Reporting states as follows:

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

- 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.
- 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
- 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.
- 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.

Accordingly, periods for which interim financial statements are required to be presented are provided herein below

(i) Entity publishes Interim financial reports quarterly

The entity will present the following financial statements (condensed or complete) in its interim financial report of 30th September, 20X1:

Balance sheet at	30th September 20X1	31st March 20X1	-	-
Statement of profit and loss for	3 months ended 30th September 20X1	3 months ended 30th September 20X0	6 months ended 30th September 20X1	6 months ended 30th September 20X0
Statement of changes in equity for	6 months ended 30th September 20X1	6 months ended 30th September 20X0		
Statement of cash flows for	6 months ended 30th September 20X1	6 months ended 30th September 20X0	-	-

(ii) Entity publishes interim financial reports half-yearly

The entity's financial year ends 31st March. The entity will present the following financial statements (condensed or complete) in its half-yearly interim financial report of 30th September, 20X1:

Balance sheet at	30th September, 20X1	31st March, 20X1
Statement of profit and loss for	6 months ending 30th September, 20X1	6 months ending 30 th September, 20X0
Statement of changes in equity for	6 months ending 30th September 20X1	6 months ending 30th September 20X0
Statement of cash flows for	6 months ending 30th September 20X1	6 months ending 30th September 20X0

Illustration 12 (RTP Nov'22)

PQR Ltd. is preparing its interim financial statements for quarter 3 of the year. How the following transactions and events should be dealt with while preparing its interim financials:

- It makes employer contributions to government-sponsored insurance funds that are assessed on an annual basis. During Quarter 1 and Quarter 2 larger amount of payments for this contribution were made, while during the Quarter 3 minor payments were made (since contribution is made upto a

certain maximum level of earnings per employee and hence for higher income employees, the maximum income reaches before year end).

- (ii) The entity intends to incur major repair and renovation expense for the office building. For this purpose, it has started seeking quotations from vendors. It also has tentatively identified a vendor and expected costs that will be incurred for this work.
- (iii) The company has a practice of declaring bonus of 10% of its annual operating profits every year. It has a history of doing so.

Solution:

Paragraph 28 of Ind AS 34, Interim Financial Reporting states that an entity shall apply the same accounting recognition and measurement principles in its interim financial statements as are applied in its annual financial statements.

Further, paragraphs 32 and 33 of Ind AS 34, Interim Financial Reporting state that for assets, the same tests of future economic benefits apply at interim dates and at the end of an entity's financial year. Costs that, by their nature, would not qualify as assets at financial year-end would not qualify at interim dates either. Similarly, a liability at the end of an interim reporting period must represent an existing obligation at that date, just as it must at the end of an annual reporting period.

An essential characteristic of income (revenue) and expenses is that the related inflows and outflows of assets and liabilities have already taken place. If those inflows or outflows have taken place, the related revenue and expense are recognised otherwise not. The Conceptual Framework does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities.

Considering the above guidance, while preparing its interim financials, the transactions and events of the given case should be dealt with as follows:

- (i) If employer contributions to government-sponsored insurance funds are assessed on an annual basis, the employer's related expense is recognised using an estimated average annual effective contribution rate in its interim financial statements, even though a large portion of the payments have been made early in the financial year. Accordingly, it should work out an average effective contribution rate and account for the same accordingly, in its interim financials.
- (ii) The cost of a planned overhaul expenditure that is expected to occur in later part of 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.
- (iii) 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 in this regard.

A liability for bonus may arise out of legal agreement or constructive obligation because of which it has no alternative but to pay the bonus and accordingly, needs to be accrued in the annual financial statements.

Bonus liability is accrued in interim financial statements on the same basis as they are accrued for annual financial statements. In the instant case, bonus liability of 10% of operating profit for the year to date may be accrued.

In the given case, since the company has past record of declaring annual bonus every year, the same may be accrued using a reasonable estimate (applying the principles of Ind AS 19, Employee Benefits) while preparing its interim results.

Question 1 - (PAST EXAM - Nov 2018)

Navya Limited manufacturer of ceramic tiles has shown a net profit of ₹ 15,00,000 for the first quarter of 2018-2019. Following adjustments were made while computing the net profit:

- (i) Bad debts of ₹ 1,64,000 incurred during the quarter. 75% of the bad debts have been deferred for the next three quarters (25% for each quarter).
- (ii) Sales promotion expenses of ₹ 5,00,000 incurred in the first quarter and 90% expenses deferred to the next three quarters (30% for each quarter) on the basis that the sales in these quarters will be high in comparison to first quarter.
- (iii) Additional depreciation of ₹ 3,50,000 resulting from the change in the method of depreciation has been taken into consideration.
- (iv) Extra-ordinary loss of ₹ 1,36,000 incurred during the quarter has been fully recognized in this quarter.

Discuss the treatment required under Ind AS 34 and ascertain the correct net profit to be shown in the Interim Financial report of first quarter to be presented to the Board of Directors. (5 Marks)

Solution

As per Ind AS 34, Interim Financial Reporting, the quarterly net profit should be adjusted and restated as follows:

- (i) Bad debts of ₹ 1,64,000 have been incurred during current quarter. Out of this, the company has deferred 75% i.e. ₹ 1,23,000 to the next 3 quarters. This treatment is not correct as the expenses incurred during an interim reporting period should be recognised in the same period unless conditions mentioned in Ind AS 34 are fulfilled. Accordingly, ₹ 1,23,000 should be deducted from the net profit of the current quarter ₹ 15,00,000.
- (ii) Deferment of sales promotion expenses of ₹ 4,50,000 is not correct. It should be charged in the quarter in which the expenses have been incurred. Hence, it should be charged in the first quarter only.
- (iii) Recognising additional depreciation of ₹ 3,50,000 in the same quarter is correct and is in tune with Ind AS 34.
- (iv) The treatment of extra-ordinary loss of ₹ 1,36,000 being recognised in the same quarter is correct.

Thus considering the above, the correct net profits to be shown in Interim Financial Report of the third quarter shall be ₹ 15,00,000 - ₹ 1,23,000 - ₹ 4,50,000 = ₹ 9,27,000.

Question 2 (MTP Nov'23)

ABC Ltd. requires assistance on whether the following revenue can be anticipated or cost can be deferred as of 30th June, 20X1 while preparing the interim financial statements:

- (i) Dividend income from its investment which is declared in September of every year.
- (ii) 60% of the advertising cost for the whole year is incurred by ABC Ltd. in the first quarter and the remaining 40% in the second quarter. (5 Marks)

Solution:

Paragraphs 37 and 38 of Ind AS 34, Interim Financial Reporting state that 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. Additionally, some entities consistently earn more revenues in certain interim periods of a financial year than in other interim periods, for example, seasonal revenues of retailers. Such revenues are recognised when they occur.

Further, for costs incurred unevenly during the financial year, para 39 of Ind AS 34 states that 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.

In view of the above guidance, in the given case, dividend income received by ABC Limited cannot be anticipated and recognised in financial statements as of 30th June, 20X1. Further, considering that 60% of advertising cost for the whole year has been incurred by ABC Ltd during the first quarter and 40% in the second quarter, it is a cost incurred unevenly. Applying principles of paragraph 39, it is not appropriate to defer the charge of an incurred advertising expense (60% of whole year cost) at the end of the quarter. Accordingly, all the advertising costs incurred till 30th June, 20X1 should be charged to P&L while preparing its financial statements as of 30th June, 20X1.

IND AS 36 – IMPAIRMENT OF ASSETS

Illustration 1

The carrying value of a building in the books of Sun Ltd. as at March 31, 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.

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 organization. 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.

Illustration 3

Mars Ltd. gives the following estimates of cash flows relating to property, plant and equipment on 31-03-20X4. 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

Calculate impairment loss, if any on the property, plant and equipment. Also calculate the revised carrying amount and revised depreciation of property, plant and equipment.

Solution:

(a) Calculation of Carrying Amount on 31st March, 20X4

Particular	Amount
Original Cost on 1 st April, 20X1	20,000
Less: Depreciation $\frac{(20000 - 500) \times 3}{8 \text{ Years}}$	(7,313)
Carrying Amount	<u>12,687</u>

(b) Calculation of Value in Use

Year	Cash Flows	P.V.	Amount
20X4-20X5	2,000	.870	1,740
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	<u>1,243</u>
Total			<u>9,513</u>

(c) Calculation of Recoverable Amount

Particular	Amount
Value in Use	9,513
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

= Revised Carrying Amount – Residual Value

Remaining Life

= $\frac{10,000 - 500}{5} = 1,900$

5

Illustration 4

Jupiter Ltd, a leading manufacturer of steel is having a furnace, which is carried in the balance sheet on 31.03.20X1 at ₹250 lakh. As at that date the value in use and Fair value is ₹200 lakh. The cost of disposal is ₹13lakh.

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

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. What would be the impact of impairment loss on related deferred tax asset / liability against the revised carrying amount of asset?

Solution

The effect of the impairment loss is as follows:

	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 utilized.

Illustration 6

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. How the impairment loss is to be accounted for?

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. Thus, there is no impairment loss

Illustration 7

Entity A acquires Entity B for ₹ 50 million, of which ₹ 35 million is the fair value of the identifiable assets acquired and liabilities assumed. The acquisition of B Ltd. is to be integrated into two of Entity A's CGUs with the net assets being allocated as follows:

	₹ in million		
	CGU 1	CGU 2	Total
Fair value of acquired identifiable tangible and intangible assets	25	10	35

In addition to the net assets acquired that are assigned to CGU 2, the acquiring entity expects CGU 2 to benefit from certain synergies related to the acquisition (e.g. CGU 2 is expected to realise higher sales of its products because of access to the acquired entity's distribution channels). There is no synergistic goodwill attributable to other CGUs.

Entity A allocated the purchase consideration of the acquired business to CGU 1 and CGU 2 as ₹ 33 million and ₹ 17 million respectively.

Determine the allocation of goodwill to each CGU?

Solution:

If goodwill is allocated to the CGUs based on the difference between the purchase consideration and the fair value of net assets acquired ie direct method, the allocation would be as follows:

(All figures are ₹ in million, unless otherwise specified)

	CGU 1	CGU 2	Total
Allocation of Purchase consideration	33	17	50
Less: Acquired identifiable tangible and intangible assets	(25)	(10)	(35)
Goodwill assigned to CGUs	8	7	15

Illustration 8

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 CGUA and ₹38 million for CGUB.

Required: 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).

Illustration 9

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.

How to account for the impairment loss of machine in above scenarios?

Solution

- The recoverable amount of the machine alone cannot be estimated because the machine's value in use:
 - may differ from its fair value less costs of disposal ; and
 - 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.

- 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.

Illustration 10

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 of disposal is expected to be ₹2,90,000.

Calculate the impairment loss, if any. Also show the accounting treatment for reversal of impairment loss and the subsequent depreciation thereon.

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

(i) 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.

(ii) 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:-

(i) The impairment loss on goodwill cannot be reversed.

(ii) 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 recognized

	₹
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 31 st March, 20X5	2,56,000

Carrying amount of other assets after recognition of impairment loss

	₹
Carrying amount on 31 st 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 31 st March, 20X5	1,88,000

(i) 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)

(ii) Impairment loss reversal will be ₹68,000 i.e. (₹2,56,000 – ₹1,88,000). This amount is recognized as income in the statement of profit and loss for the year ended 31st March, 20X5.

(iii) The carrying amount of other assets at 31st March, 20X5 after reversal of impairment loss will be ₹2,56,000.

(iv) From 1st April, 20X5 the depreciation charge will be ₹16,000 i.e. (₹2,56,000/16)

Illustration 11

A Ltd acquires 80% shares of a subsidiary B Ltd. for ₹ 3,200 thousand. At the date of acquisition, B Ltd.'s identifiable net assets is ₹ 3,000 thousand. A elects to measure NCI at proportionate share of net identifiable assets. It recognizes

	₹ in thousand
Purchase Consideration	3,200
NCI (3,000 x 20%)	600
	3,800
Less: Net Assets	(3,000)
Goodwill	800

At the end of next financial year, B Ltd.'s carrying amount is reduced to ₹ 2,700 thousand (excluding goodwill).

Recoverable amount of B Ltd.'s assets is

Case (i) ₹ 2,000 thousand,

Case (ii) ₹ 2,800 thousand

Calculate impairment loss allocable to Parent and NCI in both the cases.

Solution:

Case (i)

₹ in thousand

Particulars	Goodwill	Other Asset	Total
Carrying amount	800	2,700	3,500
Unrecognised NCI (notional) [(800 / 80%) x 20%]	200	-	200
Notional Total	1,000	2,700	3,700
Recoverable amount	-	-	2,000
Total Impairment loss	-	-	(1,700)
Impairment loss recognised in CFS	(800)	(700)	(1,500)
Carrying amount after impairment	-	2,000	2,000

Impairment loss on:	Parent	NCI
Goodwill	(800)	-
Other assets	(560)	(140)
Total	(1,360)	(140)

Case (ii)

Particulars	Goodwill	Other Asset	Total
Carrying amount	800	2,700	3,500
Unrecognised NCI (notional) (800 / 80% x 20%)	200	-	200

Notional Total	1,000	2,700	3,700
Recoverable amount	-	-	2,800
Total Impairment loss	-	-	(900)
Impairment loss recognised in CFS (900 x 80%)	(720)	-	(720)
Carrying amount after impairment (800 – 720)	80	2,700	2,780

Impairment loss on:	Parent	NCI
Goodwill	(720)	-
Other assets	-	-
Total	(720)	-

It is to be noted that since an entity measures NCI at its proportionate interest in the net identifiable assets of a subsidiary at the acquisition date, rather than at fair value, goodwill attributable to NCI is not recognised in the parent's consolidated financial statements and so the impairment loss on such goodwill not recognised.

Illustration 12

From the following details of an asset, find out:

- Impairment loss and its treatment.
- 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

$$= ₹27.30 \text{ lakh} - ₹12 \text{ lakh}$$

$$= ₹15.30 \text{ lakh}$$

Treatment of impairment loss

As per IND AS 36, impairment loss (whether of an individual asset or 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 recognizing impairment loss)	₹12 lakh
Remaining useful life	3 years
Salvage value	Nil
Annual depreciation (12/3)	₹4 lakh

Illustration 13

Venus Ltd. has an asset, which is carried in the Balance Sheet on March 31, 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:

- Calculate impairment loss.
- Prepare journal entries for adjustment of impairment loss.
- 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		100
	(Being impairment loss transferred to statement of profit and loss)		

Illustration 14

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.

Illustration 15

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.

Illustration 16

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. Examine whether the company should 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.

Illustration 17

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.

Illustration 18

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.

Illustration 19

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.

Illustration 20

XYZ Limited has a cash-generating unit 'Plant A' as on April 1, 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 March 31, 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 21

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:

- 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.
- 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

Particulars	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.

Illustration 22

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 on lease for 6 years. Determine the CGU of the building.

Solution

CGU of the building is Apex Ltd. as a whole as the primary purpose of the building is to serve as a corporate asset.

Illustration 23 (Past Exam Nov'20) (MTP March'22)

ABC Ltd. has three cash-generating units: A, B and C, the carrying amounts of which as on March 31, 20X1 are as follows:

Cash-generating units	Carrying amount	(₹ in crore) 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 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 March 31, 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.

x8 Marks

Solution

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%	36%	52%	100%
	(500/4,200)	(1,500/4,200)	(2,200/4,200)	
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

Illustration 24

Parent acquires an 80% ownership interest in Subsidiary for ₹ 2,100 on April 1, 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. Because 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 March 31, 20X2, Parent determines that there coverable 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 March 31, 20X2.

Solution

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. Because 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 March 31, 20X2

On March 31, 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 March 31, 20X2

On March 31, 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

Illustration 25

A Ltd. purchased a machinery of ₹100 crore on April 1, 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 March 31, 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 March 31, 20X2 : ₹70 crore

Calculate the impairment loss, if any.

Solution

Value in use of the machinery as on March 31, 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. Further, the impaired carrying value of ₹ 75.31 crore will be depreciated, on a straight-line basis, over the remaining four years.

Illustration 26

Assuming in the above question, as on March 31, 20X3, there is no change in the estimated future cash flows and discount rate. Fair value less costs to sell as on March 31, 20X3 is ₹40 crore. How should it be dealt with under IND AS 36?

Solution

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

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. Reason being, the underlying reasons for the original impairment have not been removed, and the service potential of the asset has not increased.

Therefore, the impairment loss of ₹4.69 crore should not be reversed.

Illustration 27 – (Past Exam – July 2021)

A Ltd. purchased an asset of ₹100 lakh on April 1, 20X0. It has useful life of 4 years with no residual value. Recoverable amount of the asset is as follows:

As on	Recoverable amount
March 31, 20X1	₹60 lakh
March 31, 20X2	₹40 lakh

March 31, 20X3	₹28 lakh

Calculate the amount of impairment loss or its reversal, if any, on March 31, 20X1, March 31, 20X2 and March 31, 20X3. (6 Marks)

Solution**As on March 31, 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 March 31, 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 March 31, 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 March 31, 20X2.

As on March 31, 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 March 31, 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 March 31, 20X3.

Illustration 28

On March 31, 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
March 31, 20X1	₹ 45/US \$

As on	Expected Exchange rate
March 31, 20X2	₹48/US \$
March 31, 20X3	₹51/US \$
March 31, 20X4	₹55/US \$

Calculate value in use as on March 31, 20X1.

Solution

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 March 31, 20X1, i.e., date of calculating value in use			₹45/US \$
Value in use as on March 31, 20X1			₹7,668

Illustration 29

Cash flow is ₹100, ₹200 or ₹300 with probabilities of 10%, 60% and 30%, respectively. Calculate expected cash flows.

Solution

Cash flow	Probability	Expected cash flow
100	10%	10
200	60%	120
300	30%	90
Total		220

The expected cash flow is ₹220.

Illustration 30

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.

Solution

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.

Illustration 31

Calculate expected cash flows in each of the following cases:

- the estimated amount falls somewhere between ₹50 and ₹250, but no amount in the range is more likely than any other amount.
- 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.
- the estimated amount will be ₹50 (10 percent probability), ₹250 (30 percent probability), or ₹100 (60 percent probability).

Solution

- the estimated expected cash flow is ₹150 $[(50 + 250)/2]$.
- the estimated expected cash flow is ₹133.33 $[(50 + 100 + 250)/3]$.
- the estimated expected cash flow is ₹140 $[(50 \times 0.10) + (250 \times 0.30) + (100 \times 0.60)]$.

Illustration 32 (RTP May'19) (Past Exam Nov'22)

Elia limited is a manufacturing company which deals in to manufacturing of cold drinks and beverages. It is having various plants across India. There is a Machinery A in the Baroda plant which is used for the purpose of bottling. There is one more machinery which is Machinery B clubbed with Machinery A. Machinery A can individually have an output and also sold independently in the open market. Machinery B cannot be sold in isolation and without clubbing with Machine A it cannot produce output as well. The Company considers this group of assets as a Cash Generating Unit and an Inventory amounting to 2 Lakh and Goodwill amounting to 1.50 Lakhs is included in such CGU.

Machinery A was purchased on 1st April 2013 for ₹10 Lakhs and residual value is 50 thousands. Machinery B was purchased on 1st April, 2015 for 5 Lakhs with no residual value. The useful life of both Machine A and B is 10 years. The Company expects following cash flows in the next 5 years pertaining to Machinery A. The incremental borrowing rate of the company is 10%.

Year	Cash Flows from Machinery A
1	1,50,000
2	1,00,000
3	1,00,000
4	1,50,000
5	1,00,000 (excluding Residual Value)
Total	6,00,000

On 31st March, 2018, the professional valuers have estimated that the current market value of Machinery A is 7 lakhs. The valuation fee was 1 lakh. There is a need to dismantle the machinery before delivering it to the buyer. Dismantling cost is 1.50 lakhs. Specialised packaging cost would be 25 thousand and legal fees would be 75 thousand.

The Inventory has been valued in accordance with Ind AS 2. The recoverable value of CGU is ₹10 Lakh as on 31st March, 2018. In the next year, the company has done the assessment of recoverability of the CGU and found that the value of such CGU is 11 Lakhs ie on 31st March, 2019. The Recoverable value of Machine A is 4,50,000 and combined Machine A and B is ₹7,60,000 as on 31st March, 2019.

Required:

- Compute the impairment loss on CGU and carrying value of each asset after charging impairment loss for the year ending 31st March, 2018 by providing all the relevant working notes to arrive at such calculation.
- Compute the prospective depreciation for the year 2018-2019 on the above assets.
- Compute the carrying value of CGU as at 31st March, 2019. (8 Marks)

Solution

(a) Computation of impairment loss and carrying value of each of the asset in CGU after impairment loss

(i) Calculation of carrying value of Machinery A and B before impairment

<u>Machinery A</u>	

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Cost (A)	10,00,000
Residual Value	50,000
Useful life	10 years
Useful life already elapsed	5 years
Yearly depreciation (B)	95,000
WDV as at 31st March, 2018 [A- (B x 5)]	5,25,000
Machinery B	
Cost (C)	5,00,000
Residual Value	
Useful life	10 years
Useful life already elapsed	3 years
Yearly depreciation (D)	50,000
WDV as at 31st March, 2018 [C- (D x 3)]	3,50,000

(ii) Calculation of Value-in-use of Machinery A

Period	Cash Flows (₹)	PVF	PV
1	1,50,000	0.909	1,36,350
2	1,00,000	0.826	82,600
3	1,00,000	0.751	75,100
4	1,50,000	0.683	1,02,450
5	1,00,000	0.621	62,100
5	50,000	0.621	31,050
Value in use			4,89,650

(iii) Calculation of Fair Value less cost of disposal of Machinery A

Fair Value	7,00,000
Less: Dismantling cost	(1,50,000)
Packaging cost	(25,000)
Legal Fees	(75,000)
Fair value less cost of disposal	4,50,000

(iv) Calculation of Impairment loss on Machinery A

Carrying Value	5,25,000
Less: Recoverable Value ie higher of Value-in-use and Fair value less cost of disposal	4,89,650
Impairment Loss	35,350

(v) Calculation of Impairment loss of CGU

1. First goodwill will be impaired fully and then the remaining impairment loss of ₹ 75,000 will be allocated to Machinery A and B.

2. If we allocate remaining impairment loss to Machinery A and B on pro-rata basis, it would come to ₹ 45,000 on Machinery A. However, the impairment loss of Machinery A cannot exceed 35,350. Hence, impairment to CGU will be as follows:

	Carrying value before impairment loss	Impairment loss	Carrying value after impairment loss
	₹	₹	₹
Machinery A	5,25,000	35,350	4,89,650
Machinery B	3,50,000	39,650*	3,10,350
Inventory	2,00,000	-	2,00,000
Goodwill	1,50,000	1,50,000	-
Total	12,25,000	2,25,000	10,00,000

*Balancing figure

(b) Carrying value after adjustment of depreciation

	₹
Machinery A $[4,89,650 - \{(4,89,650 - 50,000)/5\}]$	4,01,720
Machinery B $[3,10,350 - (3,10,350/7)]$	2,66,014
Inventory	2,00,000
Goodwill	-
Total	8,67,734

(c) Calculation of carrying value of CGU as on 31st March, 2019

The revised value of CGU is 11 Lakh. However, impaired goodwill cannot be reversed. Further, the individual assets cannot be increased by lower of recoverable value or Carrying Value as if the assets were never impaired.

Accordingly, the carrying value as on 31st March, 2019 assuming that the impairment loss had never incurred, will be:

	Carrying Value	Recoverable Value	Final CV as at 31 st Mar 2019
Machinery A	4,30,000	4,50,000	4,30,000
Machinery B	3,00,000	3,10,000 (7,60,000 – 4,50,000)	3,00,000
Inventory	2,00,000	2,00,000	2,00,000
Goodwill	-		
Total	9,30,000	9,60,000	9,30,000

Hence the impairment loss to be reversed will be limited to 62,266 only (9,30,000 – 8,67,734).

Note: It is assumed that value of inventory is same in 20X9 as it was in 20X8

Illustration 33 – (MTP March'21, May'23)

E Ltd. owns a machine used in the manufacture of steering wheels, which are sold directly to major car manufacturers.

- The machine was purchased on 1st April, 20X1 at a cost of ₹ 5,00,000 through a vendor financing arrangement on which interest is being charged at the rate of 10% per annum

- During the year ended 31st March, 20X3, E Ltd. sold 10,000 steering wheels at a selling price of ₹ 190 per wheel.
- The most recent financial budget approved by E Ltd.'s management, covering the period 1st April, 20X3 – 31st March, 20X8, including that the company expects to sell each steering wheel for ₹ 200 during 20X3-20X4, the price rising in later years in line with a forecast inflation of 3% per annum.
- During the year ended 31st March, 20X4, E Ltd. expects to sell 10,000 steering wheels. The number is forecast to increase by 5% each year until 31st March, 20X8.
- E Ltd. estimates that each steering wheel costs ₹ 160 to manufacture, which includes
- ₹ 110 variable costs, ₹ 30 share of fixed overheads and ₹ 20 transport costs.
- Costs are expected to rise by 1% during 20X4-20X5, and then by 2% per annum until 31st March, 20X8.
- During 20X5-20X6, the machine will be subject to regular maintenance costing ₹ 50,000.
- In 20X3-20X4, E Ltd. expects to invest in new technology costing ₹ 1,00,000. This technology will reduce the variable costs of manufacturing each steering wheel from ₹ 110 to ₹ 100 and the share of fixed overheads from ₹ 30 to ₹ 15 (subject to the availability of technology, which is still under development).
- E Ltd. is depreciating the machine using the straight line method over the machine's 10 year estimated useful life. The current estimate (based on similar assets that have reached the end of their useful lives) of the disposal proceeds from selling the machine is ₹ 80,000 net of disposal costs. E Ltd. expects to dispose of the machine at the end of March, 20X8.
- E Ltd. has determined a pre-tax discount rate of 8%, which reflects the market's assessment of the time value of money and the risks associated with this asset.

Assume a tax rate of 30%. What is the value in use of machine in accordance with Ind AS 36? (10 Marks)

Solution:

Calculation of the value in use of the machine owned by E Ltd. includes the projected cash inflow (i.e. sales income) from the continued use of the machine and projected cash outflows that are necessarily incurred to generate those cash inflows (i.e. cost of goods sold). Additionally, projected cash inflows include ₹ 80,000 from the disposal of the asset in March, 20X8. Cash outflows include routing capital expenditures of ₹ 50,000 in 20X5-20X6

As per Ind AS 36, estimates of future cash flows shall not include:

- Cash inflows from receivables
- Cash outflows from payables
- Cash inflows or outflows expected to arise from future restructuring to which an entity is not yet committed
- Cash inflows or outflows expected to arise from improving or enhancing the asset's performance
- Cash inflows or outflows from financing activities
- Income tax receipts or payments

Hence in this case, cash flows do not include financing interest (i.e. 10%), tax (i.e. 30%) and capital expenditures to which E Ltd. has not yet committed (i.e. ₹ 1,00,000). They also do not include any savings in cash outflows from these capital expenditure, as required by Ind AS 36.

The cash flows (inflows and outflows) are presented below in nominal terms. They include an increase of 3% per annum to the forecast price per unit (B), in line with forecast inflation. The cash flows are discounted by applying a discount rate (8%) that is also adjusted for inflation.

Note: Figures are calculated on full scale and then rounded off to the nearest absolute value.

Year ended	20X3-20X4	20X4-20X5	20X5-20X6	20X6-20X7	20X7-20X8	Value in use
Quantity (A)	10,000	10,500	11,025	11,576	12,155	
Price per unit (B)	₹ 200	₹ 206	₹ 212	₹ 219	₹ 225	

Estimated cash inflows (C=A x B)	₹ 20,00,000	₹ 21,63,000	₹ 23,37,300	₹ 25,35,144	₹ 27,34,875	
Misc. cash inflow disposal proceeds (D)					₹ 80 000	
Total estimated cash inflows (E=C+D)	₹ 20,00,000	₹ 21,63,000	₹ 23,37,300	₹ 25,35,144	₹ 28,14,875	
Cost per unit (F)	₹ 160	₹ 162	₹ 165	₹ 168	₹ 171	
Estimated cash outflows (G = A x F)	(₹ 16,00,000)	(₹ 17,01,000)	(₹ 18,19,125)	(₹ 19,44,768)	(₹ 20,78,505)	
Misc. cash outflow: maintenance costs (H)			(₹ 50,000)			
Total estimated cash outflows (I=G+H)	(₹ 16,00,000)	(₹ 17,01,000)	(₹ 18,69,125)	(₹ 19,44,768)	(₹ 20,78,505)	
Net cash flows (J=E-I)	₹ 4,00,000	₹ 4,62,000	₹ 4,68,175	₹ 5,90,376	₹ 7,36,370	
Discount factor 8% (K)	0.9259	0.8573	0.7938	0.7350	0.6806	
Discounted future cash flows (L=J x K)	₹ 3,70,360	₹ 3,96,073	₹ 3,71,637	₹ 4,33,926	₹ 5,01,173	₹ 20,73,169

* Since the future cash flows are estimated on a pre-tax basis, the discount rate is also determined on a pre-tax basis

Illustration 34 - (RTP May'20) (MTP Oct'20)

PQR Ltd. is the company which has performed well in the past but one of its major assets, an item of equipment, suffered a significant and unexpected deterioration in performance. Management expects to use the machine for a further four years after 31 st March 20X6, but at a reduced level. The equipment will be scrapped after four years. The financial accountant for PQR Ltd. has produced a set of cash-flow projections for the equipment for the next four years, ranging from optimistic to pessimistic. CFO thought that the projections were too conservative, and he intended to use the highest figures each year. These were as follows:

	₹ '000
Year ended 31 st March 20X7	276
Year ended 31 st March 20X8	192
Year ended 31 st March 20X9	120
Year ended 31 st March 20Y0	114

The above cash inflows should be assumed to occur on the last day of each financial year. The pre-tax discount rate is 9%. The machine could have been sold at 31st March 20X6 for ₹ 6,00,000 and related selling expenses in this regard could have been ₹ 96,000. The machine had been re valued previously, and at 31st March 20X6 an amount of ₹ 36,000 was held in revaluation surplus in respect of the asset. The carrying value of the asset at 31st March 20X6 was ₹ 660,000. The Indian government has indicated that it may compensate the company for any loss in value of the assets up to its recoverable amount.

Calculate impairment loss, if any and revised depreciation of asset. Also suggest how Impairment loss, if any would be set off and how compensation from government be accounted for?

Solution

Carrying amount of asset on 31st March 20X6 = ₹ 6,60,000

Calculation of Value in Use:

Year ended	Cash flow ₹	Discount factor @ 9%	Amount ₹
31 st March, 20X7	2,76,000	0.9174	2,53,202
31 st March, 20X8	1,92,000	0.8417	1,61,606
31 st March, 20X9	1,20,000	0.7722	92,664
31 st March, 20Y0	1,14,000	0.7084	80,758

Total (Value in Use)	5,88,230

Calculation of Recoverable amount:

Particulars	Amount (₹)
Value in use	5,88,230
Fair value less costs of disposal (6,00,000 – 96,000)	5,04,000
Recoverable amount (Higher of value in use and fair value less costs of disposal)	5,88,230

Calculation of Impairment loss:

Particulars	Amount (₹)
Carrying amount	6,60,000
Less: Recoverable amount	(5,88,230)
Impairment loss	71,770

Calculation of Revised carrying amount:

Particulars	Amount (₹)
Carrying amount	6,60,000
Less: Impairment loss	(71,770)
Revised carrying amount	5,88,230

Calculation of Revised Depreciation:

Revised carrying amount – Residual value

Remaining life = $(5,88,230 - 0) / 4 = ₹ 1,47,058$ per annum

Set off of Impairment loss:

The impairment loss of ₹ 71,770 must first be set off against any revaluation surplus in relation to the same asset. Therefore, the revaluation surplus of ₹ 36,000 is eliminated against impairment loss, and the remainder of the impairment loss ₹ 35,770 (₹ 71,770 – ₹ 36,000) is charged to profit and loss.

Treatment of Government compensation:

Any compensation by government would be accounted for as such when it becomes receivable. At this time, the government has only stated that it may reimburse the company and therefore credit should not be taken for any potential government receipt.

Illustration 35 (MTP Nov'23)

On 1st January Year 1, Entity Q purchased a machine costing ₹ 2,40,000 with an estimated useful life of 20 years and an estimated zero residual value. Depreciation is computed on straight-line basis. The asset had been re-valued on 1st January Year 3 to ₹ 2,50,000, but with no change in useful life at that date. On 1st January Year 4 an impairment review showed the machine's recoverable amount to be ₹ 1,00,000 and its estimated remaining useful life to be 10 years.

Calculate:

- The carrying amount of the machine on 31st December Year 2 and the revaluation surplus arising on 1st January Year 3.
- The carrying amount of the machine on 31st December Year 3 (immediately before the impairment).
- The impairment loss recognised in the year to 31st December Year 4 and its treatment thereon
- The depreciation charge in the year to 31st December Year 4.

Note: During the course of utilization of machine, the company did not opt to transfer part of the revaluation surplus to retained earnings. (8 Marks)

Solution:

(a) Calculation of Carrying amount of machine at the end of Year 2		₹
Cost of machine		2,40,000
Accumulated depreciation for 2 years $[2 \text{ years} \times (2,40,000 \div 20)]$		(24,000)
Carrying amount of the machine at the end of Year 2		<u>2,16,000</u>
(b) Calculation of carrying amount of the machine on 31 December Year 3		₹
Carrying amount at the beginning of Year 3		2,16,000
Revaluation done at the beginning of Year 3		2,50,000
Revaluation surplus		<u>34,000</u>

(c) Calculation of Impairment loss at the end of Year 4

When machine is revalued on 1 January Year 3, depreciation is charged on the revalued amount over its remaining expected useful life.

Valuation at 1 January (re-valued amount)	2,50,000
Accumulated depreciation in Year 3 $(2,50,000 / 18)$	(13,889)
Carrying amount of the asset at the end of Year 3	2,36,111
On 1 January Year 4, recoverable amount of the machine	1,00,000
Impairment loss $(2,36,111 - 1,00,000)$	<u>1,36,111</u>

An impairment loss of ₹ 34,000 will be taken to other comprehensive income (reducing the revaluation surplus for the asset to zero)

The remaining impairment loss of ₹ 1,02,111 $(1,36,111 - 34,000)$ is recognised in the Statement of Profit and Loss for the Year 4.

(d) Calculation of depreciation charge in the Year 4

Carrying value of the machine at the beginning of Year 4	₹ 1,00,000
Estimated remaining useful life	10 years
Depreciation charge is $(₹ 1,00,000 / 10 \text{ years})$	₹ 10,000

Question 1 - (RTP Nov'20) *

The UK entity with a sterling functional currency has a property located in US, which was acquired at a cost of US\$ 1.8 million when the exchange rate was £1 = US\$ 1.60. The property is carried at cost. At the balance sheet date, the recoverable amount of the property (as a result of an impairment review) amounted to US\$ 1.62 million, when the exchange rate £1 = US\$ 1.80. Compute the amount which is to be reported in Profit & Loss of UK entity as a result of impairment, if any. Ignore depreciation. Also, analyse the total impairment loss on account of change in value due to impairment component and exchange component.

Solution:

Ignoring depreciation, the loss that would be reported in the Profit and Loss as a result of the impairment is as follows:

	£
*Carrying value at balance sheet date-US\$ 16,20,000 @ £ 1.8 =	9,00,000
Historical cost- US\$ 18,00,000 @ £ 1.6 =	11,25,000
Impairment loss recognised in profit and loss	(2,25,000)
The components of the Impairment loss can be analysed as follows:	
Change in value due to impairment = US\$ 1,80,000 @ £ 1.8 =	(1,00,000)
Exchange component of change =	(1,25,000)
US\$ 18,00,000 @ 1.8 – US\$ 18,00,000 @ £ 1.6	

*Recoverable amount being less than cost becomes the carrying value.

Question 2 - (RTP May'21, Nov'23)

On 31 March 20X1, Vision Ltd acquired 80% of the equity shares of Mission Ltd for ₹ 190 million. The fair values of the net assets of Mission Ltd that were included in the consolidated statement of financial position of Vision Ltd at 31 March 20X1 were ₹ 200 million. It is the Group's policy to value the non-controlling interest in subsidiaries at the date of acquisition at its proportionate share of the fair value of the subsidiaries' identifiable net assets.

On 31 March 20X4, Vision Ltd carried out its annual review of the goodwill on consolidation of Mission Ltd and found evidence of impairment. No impairment had been evident when the reviews were carried out at 31 March 20X2 and 31 March 20X3. The review involved allocating the assets of Mission Ltd into three cash-generating units and computing the value in use of each unit. The carrying values of the individual units before any impairment adjustments are given below:

	Unit A ₹ in million	Unit B ₹ in million	Unit C ₹ in million
Intangible assets	30	10	-
Property, Plant and Equipment	80	50	60
Current Assets	60	30	40
Total	170	90	100
Value in use of unit	180	66	104

It was not possible to meaningfully allocate the goodwill on consolidation to the individual cash generating units but all the other net assets of Mission Ltd are allocated in the table shown above.

The intangible assets of Mission Ltd have no ascertainable market value but all the current assets have a market value that is at least equal to their carrying value. The value in use of Mission Ltd as a single cash-generating unit on 31 March 20X4 is ₹ 350 million.

Discuss and compute the accounting treatment of impairment of goodwill as per Ind AS 36?

Solution:

The goodwill on consolidation of Mission Ltd that is recognized in the consolidated balance sheet of Vision Ltd is ₹ 30 million (₹ 190 million – 80% x ₹ 200 million). This can only be reviewed for impairment as part of

the cash generating units to which it relates. Since here the goodwill cannot be meaningfully allocated to the units, the impairment review is in two parts.

Units A and C have values in use that are more than their carrying values. However, the value in use of Unit B is less than its carrying amount. This means that the assets of unit B are impaired by ₹ 24 million (₹ 90 million – ₹ 66 million). This impairment loss will be charged to the statement of profit and loss.

Assets of Unit B will be written down on a pro-rata basis as shown in the table below: (₹ in million)

Asset	Impact on carrying value		
	Existing	Impairment	Revised
Intangible assets	10	(4)	6
Property, plant and equipment	50	(20)	30
Current assets	30	Nil*	30
Total	90	(24)	66

* The current assets are not impaired because they are expected to realize at least their carrying value when disposed of.

Following this review, the three units plus the goodwill are reviewed together i.e. treating Mission Limited as single cash generating Unit. The Impact of this is shown in the following table, given that the recoverable amount of the business as a whole is ₹ 350 million: (₹ in million)

Component	Impact of Impairment review on carrying value		
	Existing	Impairment	Revised
Goodwill (see note below)	37.50	(23.50)	14.00
Unit A	170.00	Nil	170.00
Unit B (revised)	66.00	Nil	66.00
Unit C	100.00	Nil	100.00
Total	373.50	(23.50)	350.00

Note: As per Appendix C of Ind AS 36, given that the subsidiary is 80% owned the goodwill must first be grossed up to reflect a notional 100% investment. Therefore, the goodwill will be grossed up to ₹ 37.50 million (₹ 30 million $\times$ 100/80).

The impairment loss of ₹ 23.50 million is all allocated to goodwill, leaving the carrying values of the individual units of the business as shown in the table immediately above.

The table shows that the notional goodwill that relates to a 100% interest is written down by ₹ 23.50 million to ₹ 14.00 million. However, in the consolidated financial statements the goodwill that is recognized is based on an 80% interest so the loss that is actually recognized is ₹ 18.80 million (₹ 23.50 million $\times$ 80%) and the closing consolidated goodwill figure is ₹ 11.20 million (₹ 14.00 million $\times$ 80%) or (₹ 30 million – ₹ 18.80 million).

Question 3 (MTP April'22)

On 1st April, 20X1, Sun Ltd. has acquired 100% shares of Earth Ltd. for ₹ 30 lakh. Sun Ltd. has 3 cash-generating units A, B and C with fair value of ₹ 12 lakh, ₹ 8 lakh and ₹ 4 lakh respectively. The company recognizes goodwill of ₹ 6 lakh 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 with the Ind AS. If not, advise the correct treatment in accordance with relevant Ind AS. (6 Marks)

Solution:

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.

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'

IND AS 37 – PROVISIONS CONTINGENT LIABILITIES AND CONTINGENT ASSETS

Illustration 1

ABC Limited is an automobile component manufacturer. The automobile manufacturer has specified a delivery schedule, non-adherence to which will entail a penalty. As on 31st March, 20X1, the reporting date, the manufacturer has a delivery scheduled for June 20X2. However, the manufacturer is aware that he will not be able to meet the delivery schedule in June 20X2.

Determine whether the entity has a present obligation as at 31st March, 20X1, requiring recognition of provision.

Solution

In this case, there is no present obligation arising out of a past event as the goods are scheduled for delivery in June 20X2 and there is no delay as at 31st March, 20X1. Hence, there is no present obligation to pay the penalty in the current year. Therefore, there is no present obligation to recognise the provision.

Illustration 2

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. 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.

Illustration 3

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.

Illustration 4

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.

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:

$$(75\% \text{ of nil}) + (20\% \text{ of } 1\text{m}) + (5\% \text{ of } 4\text{m}) = ₹4,00,000$$

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 ($₹30,00,000 \times 5\%$) would be made.

So, the liability will be recognised at = ₹30,00,000 + ₹1,50,000 = ₹31,50,000.

Illustration 7

ABC Ltd. has an obligation to restore the seabed for the damage it has caused in the past. It has to pay ₹ 10,00,000 cash on 31st March 20X3 relating to this liability. ABC Ltd.'s management considers that 5% is an appropriate discount rate. The time value of money is considered to be material.

Calculate the amount to be provided for at 31st March 20X1 for the costs of restoring the seabed.

Solution

Discounting factor of 5% for 2nd year as on 31st March 20X1 = $(1/1.05)^2 = 0.907$ The present value of the provision as on 31st March 20X1 is = ₹ 10,00,000 $\times$ 0.907 = ₹ 9,07,000

The amount of increase in the provision resulting from unwinding of discounting to reflect the passage of time should be included as an element of borrowing cost in determining the profit or loss for the year.

The provision should be initially recognised at ₹ 9,07,000 which is the present value of ₹ 10,00,000 discounted at 5% for two years. At the end of year 1 i.e. 31st March 20X2, the provision increases to ₹ 9,52,350, and the difference of ₹ 45,350 is recognised as borrowing cost. Similarly, for the year ending 31st March 20X3, the provision will increase to 10,00,000 and the increase being recognised as borrowing cost. Consequently, at the end of year 2 the amount of provision will be equal to the amount due, i.e., ₹ 10,00,000.

Note: There may be some difference in amount due to approximation (limiting discounting factor to 3 place decimal), which can be overcome either by full scale calculation or adjustment at the end.

Illustration 8

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.

Illustration 9

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 ($₹30,00,000 \times 30\%$) 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.

Illustration 10

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 ($₹1,00,00,000 \times 0.827$).

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 ($₹1,00,00,000 \times 0.909$).

As per the standard, the difference between the two present values i.e., 8,30,000 ($90,90,000 - 82,60,000$) is recognised as a finance 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.

Illustration 11

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.

Illustration 12

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 contract, 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.

Illustration 13

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.

Illustration 14

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.

Illustration 15

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 Authority had more than 50% chance of winning the appeal. Advise how the company should account for these transactions in the financial year 20X1-20X2.

Solution

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 exists 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 of ₹1,00,00,000.

Illustration 16 (Past Exam May'23)

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? (4 Marks)

Solution

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.

Illustration 17 (This Ques is Deleted from ICAI Study Material)

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 there from 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?

Solution

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.

Illustration 18 – (RTP Nov'18, MTP Nov'23)

U Ltd. is a large conglomerate with a number of subsidiaries. It is preparing consolidated financial statements as on 31st March 2018 as per the notified Ind AS. The financial statements are due to be authorised for issue on 15th May 2018. It is seeking your assistance for some transactions that have taken place in some of its subsidiaries during the year.

G Ltd. is a wholly owned subsidiary of U Ltd. engaged in management consultancy services. On 31st January 2018, the board of directors of U Ltd. decide of to discontinue the business of G Ltd. from 30th April 2018. They made a public announcement of their decision on 15th February 2018.

G Ltd. does not have many assets or liabilities and it is estimated that the outstanding trade receivables and payables would be settled by 31st May 2018. U Ltd. would collect any amounts still owed by G Ltd's customers after 31st May 2018. They have offered the employees of G Ltd. termination payments or alternative employment opportunities.

Following are some of the details relating to G Ltd.:

- On the date of public announcement, it is estimated by G Ltd. that it would have to pay 540 lakhs as termination payments to employees and the costs for relocation of employees who would remain with the Group would be ₹ 60 lakhs. The actual termination payments totalling to ₹ 520 lakhs were made in full on 15th May 2018. As per latest estimates made on 15th May 2018, the total relocation cost is ₹ 63 lakhs.
 - G Ltd. had taken a property on operating lease, which was expiring on 31st March 2022. The present value of the future rentals (using an appropriate discount rate) is ₹ 430 lakhs. On 15th May 2018, G Ltd. made a payment to the lessor of ₹ 410 lakhs in return for early termination of the lease.
- The loss after tax of G Ltd. for the year ended 31st March 2018 was ₹ 400 lakhs. G Ltd. made further operating losses totalling ₹ 60 lakhs till 30th April 2018.

How should U Ltd. present the decision to discontinue the business of G Ltd. in its consolidated statement of comprehensive income as per Ind AS?

What are the provisions that the Company is required to make as per Ind AS 37?

(8 Marks)

Solution

A discontinued operation is one that is discontinued in the period or classified as held for sale at the year end. The operations of G Ltd were discontinued on 30th April 2018 and therefore, would be treated as discontinued operation for the year ending 31st March 2019. It does not meet the criteria for held for sale since the company is terminating its business and does not hold these for sale.

As per para 72 of Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets', restructuring includes sale or termination of a line of business. A constructive obligation to restructure arises when:

- (a) an entity has a detailed formal plan for the restructuring

(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.

The Board of directors of U Ltd have decided to terminate the operations of G Ltd. from 30th April 2018. They have made a formal announcement on 15th February 2018, thus creating a valid expectation that the termination will be implemented. This creates a constructive obligation on the company and requires provisions for restructuring.

A restructuring provision includes only the direct expenditures arising from the restructuring that are necessarily entailed by the restructuring and are not associated with the ongoing activities of the entity.

The termination payments fulfil the above condition. As per Ind AS 10 'Events after Reporting Date', events that provide additional evidence of conditions existing at the reporting date should be reflected in the financial statements. Therefore, the company should make a provision for ₹ 520 lakhs in this respect.

The relocation costs relate to the future conduct of the business and are not liabilities for restructuring at the end of the reporting period. Hence, these would be recognised on the same basis as if they arose independently of a restructuring.

The operating lease would be regarded as an onerous contract. A provision would be made at the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. Hence, a provision shall be made for ₹ 410 lakhs.

Further operating losses relate to future events and do not form a part of the closure provision.

Therefore, the total provision required = ₹ 520 lakhs + ₹ 410 lakhs = ₹ 930 lakhs

Illustration 19

A company manufacturing and supplying process control equipment is entitled to duty draw back 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 20X1-20X2 the company has exceeded the specified limit of turnover by the end of the reporting period. However, duty drawback can be claimed on filing of application within the stipulated time or on discretion of the Department if filing of application is late. 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. What would be the treatment of duty drawback credit as per the given information?

Solution

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 drawback. However, the application for the same has been filed after the stipulated time. Therefore, credit of duty drawback was discretionary in the hands of the Department. Since the claim was to be accrued only after filing of application, its accrual will be considered in the year 20X2-20X3 only.

Accordingly, the duty drawback credit is a contingent asset as at the end of the reporting period 20X1-20X2, which will be realised when the Department credits the same.

As per para 35 of Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets, 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 drawback credit which was contingent asset for the F.Y. 20X1-20X2 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. 20X2-20X3.

Illustration 20 - (RTP May'20) (MTP May'23)

Entity XYZ entered into a contract to supply 1000 television sets for ₹ 2 million. An increase in the cost of inputs has resulted into an increase in the cost of sales to ₹ 2.5 million. The penalty for non-performance of the contract is expected to be ₹ 0.25 million. Is the contract onerous and how much provision in this regard is required? **(5 Marks)**

Solution

Ind AS 37 "Provisions, Contingent Liabilities and Contingent Assets" 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".

Paragraph 68 of Ind AS 37 states that "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".

In the instant case, cost of fulfilling the contract is ₹ 0.5 million (₹ 2.5 million – ₹ 2 million) and cost of exiting from the contract by paying penalty is ₹ 0.25 million.

In accordance with the above reproduced paragraph, it is an onerous contract as cost of meeting the contract exceeds the economic benefits.

Therefore, the provision should be recognised at the best estimate of the unavoidable cost, which is lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it, i.e., at ₹ 0.25 million (lower of ₹ 0.25 million and ₹ 0.5 million).

Illustration 21

Marico has an obligation to restore environmental damage in the area surrounding its factory. Expert advice indicates that the restoration will be carried out in two distinct phases; the first phase requiring expenditure of ₹ 2 million to remove the contaminated soil from the area and the second phase, commencing three years later from the end of first phase, to replant the area with suitable trees and vegetation. The estimated cost of replanting is ₹ 3.5 million. Marico uses a cost of capital (before taxation) of 10% and the expenditure, when incurred, will attract tax relief at the company's marginal tax rate of 30%. Marico has not recognised any provision for such costs in the past and today's date is 31 March 20X2. The first phase of the clean up will commence in a few months time and will be completed on 31 March 20X3 when the first payment of ₹ 2 million will be made. Phase 2 costs will be paid three years later from the end of first phase. Calculate the amount to be provided at 31 March 20X2 for the restoration costs.

Solution

Year	Cash Flow	10% Discount factor	Present Value
20X2-20X3	20,00,000	0.909	18,18,000
20X5-20X6	35,00,000	0.683	<u>23,90,500</u>
Provision required at 31 March 20X2			<u>42,08,500</u>

The provision is calculated using the pre-tax costs and a pre-tax cost of capital. The fact that the eventual payment will attract tax relief will be reflected in the recognition of a deferred tax asset for the deductible temporary difference (assuming that the recognition criteria for deferred tax assets are met).

Question 1 - (MTP March'19)

During the year, QA Ltd. delivered manufactured products to customer K. The products were faulty and on 1st October, 2016 customer K commenced legal action against the Company claiming damages in respect of losses due to the supply of faulty product. Upon investigating the matter, QA Ltd. discovered that the products were faulty due to defective raw material procured from supplier F. Therefore, on 1st December, 2016, the Company commenced legal action against F claiming damages in respect of the supply of defective raw materials.

QA Ltd. has estimated that it's probability of success of both legal actions, the action of K against QA Ltd. and action of QA Ltd. against F, is very high.

On 1st October, 2016, QA Ltd. has estimated that the damages it would have to pay K would be Rs. 5 crores. This estimate was revised to Rs. 5.2 crores as on 31st March, 2017 and Rs. 5.25 crores as at 15th May, 2017. This case was eventually settled on 1st June, 2017, when the Company paid damages of Rs. 5.3 crores to K.

On 1st December, 2016, QA Ltd. had estimated that it would receive damages of Rs. 3.5 crores from F. This estimate was revised to Rs. 3.6 crores as at 31st March, 2017 and Rs. 3.7 crores as on 15th May, 2017. This case was eventually settled on 1st June, 2017 when F paid Rs. 3.75 crores to QA Ltd. QA Ltd. had, in its financial statements for the year ended 31st March, 2017, provided Rs. 3.6 crores as the financial statements were approved by the Board of Directors on 26th April, 2017.

(i) Whether the Company is required to make provision for the claim from customer K as per applicable Ind AS? If yes, please give the rationale for the same.

(ii) If the answer to (a) above is yes, what is the entry to be passed in the books of account as on 31st March, 2017? Give brief reasoning for your choice.

(A)	Statement of Profit and Loss A/c Dr.	Rs. 5.2 crores	
	To Current Liability A/c		Rs. 5.2 crores
(B)	Statement of Profit and Loss A/c Dr.	Rs. 5.3 crores	
	To Non-Current Liability A/c		Rs. 5.3 crores
(C)	Statement of Profit and Loss A/c Dr.	Rs. 5.25 crores	
	To Current Liability A/c		Rs. 5.25 crores

(iii) What will the accounting treatment of the action of QA Ltd. against supplier F as per applicable Ind AS?

SOLUTION:

(i) Yes, QA Ltd. is required to make provision for the claim from customer K as per Ind AS 37 since the claim is a present obligation as a result of delivery of faulty goods manufactured. Also, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations. Further, a reliable estimate of Rs. 5.2 crore can be made of the amount of the obligation while preparing the financial statements as on 31st March, 2017.

(ii) Option (A) : Statement of Profit and Loss A/c

Dr. Rs. 5.2 crore

To Current Liability A/c

Rs. 5.2 crore

(iii) As per para 31 of Ind AS 37, QA Ltd. shall not recognise a contingent asset. Here the probability of success of legal action is very high but there is no concrete evidence which makes the inflow virtually certain. Hence, it will be considered as contingent asset only and shall not be recognized. (It may be disclosed)

Question 2 - (MTP - Oct 2020)

An entity engaged in automobile sector has assessed the impact of COVID-19 outbreak on its future viability of business model. Senior Management has identified the need for restructuring some of its business activities and retrenching its employees in many areas. Senior Management is drawing up a plan for the consideration of the Board of Directors in their meeting scheduled in May 2020, which is subsequent to the reporting date of the current financial year i.e. 31 March 2020. Can the entity recognise provisions for restructuring costs in the financial statements of the current year i.e. 2019-2020?

(4 Marks)**Solution:**

In accordance with paragraph 72 of Ind AS 37, 'Provisions, Contingent Liabilities and Contingent Assets', a constructive obligation to restructure arises only when an entity has detailed formal plan for restructuring identifying the business or part of business concerned; the principal locations affected; the location, function, and approximate number of employees who will be compensated for terminating their services; the expenditures that will be undertaken; and when the plan will be implemented; and 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.

Further, paragraph 75 of Ind AS 37 provides that 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.

In the given case, since COVID-19 pandemic impact started during March 2020, it is likely that the senior management started drawing up the plan for restructuring some of its business activities after the end of the reporting period, i.e., 2019-2020. If that be so, as per Ind AS 37, the management decisions subsequent to reporting date do not give rise to constructive obligation as of reporting date and no provision is required for restructuring costs as at 31 March 2020.

In this regard, paragraph 75 of Ind AS 37 provides that 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

Question 3 - (RTP - Nov 2020)

In order to encourage companies and organisations to generously contribute to the Government's COVID-19 relief fund, taxation laws have been amended to reckon these contributions as deductible for the financial year ending 31st March, 2020 even if the contributions are made after the year end but within three months after year end. Government of India issued the notification on 31st March, 2020 by way of an Ordinance. Such contributions to COVID-19 funds are considered for compliance with annual spends on corporate social responsibility (CSR) for the current accounting year under the Companies Act, 2013. In this scenario, whether the contributions to COVID-19 Relief Funds made subsequent to reporting date of the current accounting period can be provided for as expenses of the current accounting period? Also show its impact on deferred tax, if any.

Solution:

According to paragraph 14 of Ind AS 37, a provision shall be made if:

- 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 as of reporting date, no provision shall be recognised for that financial year.

Government of India issued the notification on 31st March, 2020 by way of an Ordinance and hence, it is most unlikely for any entity to have a present obligation on 31st March, 2020, for such a commitment. As these conditions are not met as of reporting date of financial year 2019 - 2020, no provision should be recognised in the financial statements for that financial year.

In the fact pattern given above, the accounting implications for the financial year 2019-2020 is as follows:

- Do not recognize expense / liability for the contribution to be made subsequent to the year ended 31st March, 2020 as it does not meet the criteria of a present obligation as at the balance sheet date. However, the expected spend may be explained in the notes to the accounts as the same will also be considered in measurement of deferred tax liability.
- If the entity claims a deduction in the Income Tax return for the financial year 2019 - 2020 for that contribution made subsequent to 31st March, 2020, recognise Deferred Tax Liability as there would be a tax saving in financial year 2019 - 2020 for a spend incurred in subsequent year.

Question 4 - (PAST EXAM - Nov 2018)

Sun Limited has entered into a binding agreement with Moon Limited to buy a custom-made machine for ₹ 4,00,000. At the end of 2017-18, before delivery of the machine, Sun Limited had to change its method of production. The new method will not require the machine ordered which is to be scrapped after delivery. The expected scrap value is nil. Given that the asset is yet to be delivered, should any liability be recognized for the potential loss? If so, give reasons for the same, the amount of liability as well as the accounting entry. (4 Marks)

Solution

As per Ind AS 37, 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.

The contract entered by Sun Ltd. is an executory contract, since the delivery has not yet taken place.

Ind AS 37 is applied to executory contracts only if they are onerous.

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.

As per the facts given in the question, Sun Ltd. will not require the machine ordered. However, since it is a binding agreement, the entity cannot exit / cancel the agreement. Further, Sun Ltd. has to scrap the machine after delivery at nil scrap value.

These circumstances do indicate that the agreement/contract is an onerous contract. Therefore, a provision should be made for the onerous element of ₹ 4,00,000 i.e. the full cost of the machine.

		₹	₹
Onerous Contract Provision Expense A/c	Dr.	4,00,000	
To Provision for Onerous Contract Liability A/c			4,00,000
(Being asset to be received due to binding agreement recognized)			
Profit and Loss Account (Loss due to onerous contract)	Dr.	4,00,000	
To Onerous Contract Provision Expense A/c			4,00,000

(Being loss due to onerous contract recognized and asset derecognised)			

Question 5 – (RTP – May 2021)

A manufacturer gives warranties to the purchasers of its goods. Under the terms of the warranty, the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale to the purchasers.

On 30 April 20X1, a manufacturing defect was detected in the goods manufactured by the entity between 1 March 20X1 and 30 April 20X1.

At 31 March 20X1 (the entity's reporting date), the entity held approximately one week's sales in inventories. The entity's financial statements for the year ended 31 March 20X1 have not yet been finalised.

Three separate categories of goods require separate consideration:

Category 1—defective goods sold on or before 31 March 20X1

Category 2—defective goods held on 31 March 20X1

Category 3—defective goods manufactured in 20X1-20X2

State the accounting treatment of the above categories in accordance with relevant Ind AS.

Solution:**Category 1—defective goods sold on or before 31 March 20X1**

If customer has the option to purchase warranty separately, the warranty is a distinct service because the entity promises to provide the service to the customer in addition to the product that has the functionality described in the contract. In that case, entity shall account for the promised warranty as a performance obligation and allocate a portion of the transaction price to that performance obligation.

If a customer does not have the option to purchase a warranty separately, an entity shall account for the warranty in accordance with Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets, unless it provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications. If that is the case, then, the promised service is a performance obligation. Entity shall allocate the transaction price to the product and the service.

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.

A law that requires an entity to pay compensation if its products cause harm or damage does not give rise to a performance obligation. The entity shall account for such obligations in accordance with Ind AS 37.

Category 2—defective goods held on 31 March 20X1

At 31 March 20X1, the entity did not have a present obligation to make good the unsold defective goods that it held in inventories. Accordingly, at 31 March 20X1 the entity should not recognise a provision in respect of the defective inventories.

For this category, the detection of the manufacturing defect in April 20X1 is an adjusting event after the end of the reporting period as per Ind AS 10, Events after the End of the Reporting Period. It provides evidence of a manufacturing defect in inventories held at 31 March 20X1.

Category 3—defective goods manufactured in 20X1-20X2

At 31 March 20X1 the entity, did not have a present obligation to make good any defective goods that it might manufacture in the future. Accordingly, at 31 March 20X1 the entity should not recognise a provision in respect of the defective goods manufactured in 20X1-20X2.

For this category, the detection of the manufacturing defect in April 20X1 is a non- adjusting event after the end of the reporting period as per Ind AS 10, Events After the End of the Reporting Period.

Question 6 (RTP May'22)

XYZ Ltd. offers a six-month warranty on its small to medium sized equipment, which can be put to use by the customer with no installation support. The warranty comes with the equipment and the customer cannot purchase it separately. This equipment is typically sold at a gross margin of 40%. XYZ Ltd. has made a provision of ₹ 30,000 during the year ended 31st March, 20X2, which is approximately 1% of its gross margin on the sale of these equipment. Based on past experience, it is expected that 1% of equipment sold have been returned as faulty within the warranty period. Faulty equipment returned to XYZ Ltd. during the warranty period are scrapped and the sale value is fully refunded to the customer.

Assuming that sales occurred evenly during the year, how should XYZ Ltd. evaluate whether any additional warranty provision is required on equipment sold in the past as at 31st March, 20X2? Had the warranty period been 2 years instead of six months, what additional criteria would XYZ Ltd. need to consider?

Solution:

Calculation of additional warranty provisions:

Warranty claim covers 1% of gross margin, whereas customers are refunded the full selling price. As the goods are scrapped it is assumed XYZ Ltd has no potential for re- imbursement from its supplier regarding the faulty goods.

A calculation of warranty provision is set out below:

1% of annual gross margin is ₹ 30,000 therefore 100% of annual gross margin must be ₹ 30,00,000. Since gross margin is 40%, sales should be ₹ 75,00,000. As provide in the question that the sales are evenly spread during the year and given the six month warranty, half of the sales occurred in the second half of the year is still covered within the warranty period as follows.

	% age	Annual sales	Product under warranty at 31st March, 20X2	Percentage expected to be returned	Warranty provision
		₹	₹	₹	₹
Gross margin	40%	30,00,000			
Selling price	100%	75,00,000	37,50,000	1%	37,500

The warranty provision should therefore be increased by ₹ 7,500 (₹ 37,500 – ₹ 30,000). As the provision is expected to be used in the next 6 months no discounting is required.

If the warranty period is 2 years:

Since the outstanding period of warranties is 6 months (i.e. less than a year), no discounting is required. However, if a longer warranty period is to be given, the entity will have to take into account the effect of the time value of money. The amount of provision shall be the present value of the expenditures expected to be required to settle the warranty obligation. (Refer Para 45 of Ind AS 37)

The discount rate shall be a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability. The discount rate shall not reflect risks for which future cash flow estimates have been adjusted. (Refer Para 47 of Ind AS 37)

	% age	Annual sales	Product under warranty at 31st March, 20X2	Percentage expected to be returned	Warranty provision
		₹	₹	₹	₹
Gross margin	40%	30,00,000			
Selling price	100%	75,00,000	75,00,000	1%	75,000

The warranty provision should therefore be increased by ₹ 45,000 (₹ 75,000 – ₹ 30,000). Further discounting of provision would be required

Question 7 (RTP Nov'22)

HVCL manufactures heavy equipment for construction industry. An order for supply of 90 equipment was received from ABIL. The unit price of the equipment was agreed at ₹ 190 lakhs each. 64 equipment was supplied during the year 20X1-20X2 and balance quantity remaining to be supplied as on 31.3.20X2. HVCL has 5 equipment in its inventory as on 31.3.20X2. HVCL considered that the contract was an onerous contract and therefore, the net realisable value of inventory has been taken as value of inventory as on 31.3.20X2.

The management of HVCL contends that costs incurred towards administrative overheads, finance charges, R & D expenses, sales overhead, head quarter expenditure etc., are considered as period cost and hence not considered for creation of provision. Hence, the same have not been included in the computation of unavoidable cost.

The management of HVCL has submitted the details of costs that have been considered for creation of provision towards onerous contract:

- Material cost - includes cost of material procured, cost of freight & insurance incurred for material procurement and handling, loading and unloading charges incurred.
- Labour cost/ Factory Overheads - includes salaries and other expenses of direct production department, and also expenses allocated from indirect departments to direct department.
- Material Overheads - Includes salaries and other expenses (including expenses allocated from other departments) booked under departments linked with materials like purchases, stores and quality control.

Accordingly, provision has been made considering the above costs only. The value of provision created for 21 remaining equipment to be produced is as per the working shown below:

Particulars	Value (₹ in lakh)
(i) Cost of production (which includes material cost, labour cost/factory overhead and material overhead)	199.00
(ii) Selling price	(190.00)
(iii) Differential cost per equipment	9.00
(iv) Differential cost of ₹ 9 Lakh per equipment for 21 equipment	189.00

Whether the company's accounting treatment of cost for creation of provision towards onerous contracts is in line with the provisions of Ind AS 37?

Solution:

As per para 68 of Ind AS 37, 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. The unavoidable cost under a contract reflects the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation for penalties arising from failure to fulfilling it.

Ind AS 37 provides that the amount recognised shall be the best estimate of the expenditure required to settle the present obligation, which is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. In case of onerous contracts, an amount that an entity would rationally pay to settle the obligation would be the lower of the compensation or penalties arising from failure to fulfil the contracts and excess of unavoidable cost of meeting the obligations under the contract from the economic benefits expected to be received under it.

As per para 68 of Ind AS 37, the cost of fulfilling a contract comprises the costs that relate directly to the contract. Costs that relate directly to a contract consist of both –

- a) the incremental costs of fulfilling that contract—for example, direct labour and materials; and
- b) an allocation of other costs that relate directly to fulfilling contracts—for example, an allocation of the depreciation charge for an item of property, plant and equipment used in fulfilling that contract among others.

The unavoidable costs of meeting the obligations under the contract are only costs that:

- "are directly variable with the contract and therefore incremental to the performance of the contract;"
- do not include allocated or shared costs that will be incurred regardless of whether the entity fulfils the contract or not; and
- cannot be avoided by the entity's future actions.

Accordingly, HVCL has correctly measured the cost for creation of provision for onerous contracts by considering material cost, labour cost (to the extent it relates directly to production) and material overheads (to the extent it relates directly to production).

Further, HVCL is correct that the period cost will not be considered for measurement of cost for the purpose

Question 8 (MTP May'24)

An entity has a contract to purchase one million units of gas at 23p per unit, giving a contract price of ₹ 2,30,000. The current market price for a similar contract is 16p per unit, giving a price of ₹ 1,60,000. All of the gas purchased by the entity is used to generate electricity using dedicated assets.

Determine in the following situations whether the contract is onerous and provision is to be made when:

- (i) The electricity is sold at a profit. The electricity is sold to a wide range of customers.
- (ii) The electricity is sold at a loss, and the entity makes an overall operating loss. The electricity is sold to a wide range of customers.
- (iii) The entity sells the gas under contract, which it no longer needs, to a third party for 18p per unit (5p below cost). The entity determines that it would have to pay ₹ 55,000 to exit the purchase contract.

(6 Marks)

Solution:

- (i) The gas will be used to generate electricity, which will be sold at a profit. The economic benefits from the contract include the benefits to the entity of using the gas in its business and, because the electricity will be sold at a profit, the contract is not onerous.
- (ii) The electricity is sold to a wide range of customers. The entity first considers whether the assets used to generate electricity are impaired. To the extent that there is still a loss after the assets have been written down, a provision for an onerous contract should be recorded.

- (iii) The only economic benefit from the purchase contract costing ₹ 2,30,000 are the proceeds from the sales contract, which are ₹ 1,80,000. Therefore, a provision should be made for the onerous element of ₹ 50,000, being the lower of the cost of fulfilling the contract and the penalty cost of cancellation (₹ 55,000).

IND AS 38 – INTANGIBLE ASSETS

Illustration 1

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 arises from contractual or legal rights.

Illustration 2

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 anytime.

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.

Illustration 3

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 31 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.

Illustration 4

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 (<i>not to be considered as it is a refundable tax</i>)	-
Legal fees	87,000
Consultancy fees for implementation	1,20,000
Total cost to be capitalised	12,70,636

Illustration 5

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

Illustration 6

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 ₹10,00,000 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		Telecommunication license Dr. 520
	To Telecommunication license 500		To Software 10
	To Profit on Exchange NIL		To Profit on Exchange 510
2	Software Dr. 490		Telecommunication license Dr. 490
	Loss on Exchange Dr. 10		To Profit on Exchange 480
	To Telecommunication license 500		To Software 10
	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.		
3	Software Dr. 500		Telecommunication license Dr. 10
	To Telecommunication license 500		To Software 10

Illustration 7

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 authorized 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 totaled ₹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 recognized 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 8

Expenditure on a new production process in 20X1-20X2:

	₹
1 st April to 31 st December	2,700
1 st January to 31 st March	<u>900</u>
	<u>3,600</u>

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 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 and 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 on account of impairment loss?

Solution

1. Expenditure to be transfer 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 31 st March, 20X2	₹ 900
Add: Further expenditure during development phase	6,000
Total capital expenditure on development phase	<u>6,900</u>

4) Expenditure to be charged to profit or loss in 20X3-20X4

Opening balance of Intangible Asset	6,900
Less: Amortisation for the year (6,900 / 6)	<u>(1,150)</u>
Carrying amount of intangible asset	5,750
Less: Recoverable Amount	<u>(5,000)</u>
Amount charged to profit or loss (Impairment Loss)	<u>750</u>

5) Carrying Amount of Intangible Asset on 31st March, 20X4

Value of Intangible Asset will be recoverable amount i.e. ₹ 5,000

Illustration 9

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, 20X2 and ₹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.

Illustration 10

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 fertilizer 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 (i.e. 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) i.e. 1,56,15,615.

Amortisation for remaining years (unless the estimates are again revised) :

Year 3 = 85,000 / 3,70,000 on (10,00,00,000 – 1,11,11,111) i.e. ₹ 2,04,20,420

Year 4 = 1,05,000 / 3,70,000 on (10,00,00,000 – 1,11,11,111) i.e. ₹ 2,52,25,225

Year 5 = 1,15,000 / 3,70,000 on (10,00,00,000 – 1,11,11,111) i.e. ₹ 2,76,27,629

Illustration 11 (Past Exam Nov'23)

X Ltd. purchased a patent right on April 1, 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 April 1, 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 April 1, 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? (4 Marks)

Solution

Value as on March 31, 20X2

Original cost	₹3,00,000
Less: Amortisation	<u>(₹60,000)</u>
Net Value	<u>₹2,40,000</u>

Value as on March 31, 20X3

On April 1, 20X2, the downward revaluation 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 = ₹1,50,000 – ₹75,000 = ₹75,000.

Value as on March 31, 20X4

As of April 1, 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.

Amortisation provided for the financial year 20X3-20X4 is ₹ 75,000 (₹ 3,00,000/4)

Net value is = ₹ 3,00,000 – ₹ 75,000 = ₹ 2,25,000.

Similarly, Value as on March 31, 20X5 = ₹ 2,25,000 – ₹75,000 = ₹ 1,50,000

Value as on March 31, 20X6 = ₹ 1,50,000 – ₹75,000 = ₹ 75,000

Value as on March 31, 20X5 = ₹ 75,000 – ₹75,000 = ₹ Nil

Illustration 12 (MTP May'24)

X Pharmaceutical Ltd. seeks your opinion in respect of following accounting transactions:

1. Acquired a 4 year license to manufacture a specialized 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 the company acquired a brand with a FV 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 March 31, 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 March 31, 20X2. The technological feasibility has not yet been established.

How the above transactions will be accounted for in books of account of X Pharmaceutical Ltd? (5 Marks)

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 (DrugA) as on March 31, 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.

Illustration 13

X Ltd. is engaged in the business of publishing Journals. They acquired 100% 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.

However, the above items (a) and (b) are not forming part of the net assets acquired of ₹ 8,50,00,000.

How should the above transactions be accounted for by X Ltd?

Solution

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 the same should be expensed. The entity has insufficient control over the expected future economic benefits arising from the 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 for being identified as a separate intangible asset. However, since it is acquired as part of 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).

Illustration 14 – (RTP Dec'21) (MTP Nov'22)

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? (4 Marks)

Solution

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.

Illustration 15

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?

Solution

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. It does not meet the conditions specified to recognize an internally generated intangible asset.

Illustration 16

A software company X Ltd. is developing new software for the telecom industry. It employs 100 employees 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?

Solution

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.

Illustration 17

X Ltd. has acquired a telecom license from Government to operate mobile telephony in two states of India. Can the cost of acquisition be capitalized as an intangible asset under IND AS 38?

Solution

Cost of acquisition of the telecom license can be capitalized as an intangible asset under the head Licenses, as it will lead to future economic benefits for X Ltd.

Illustration 18

X Ltd. purchased a standardized 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?

Solution

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.

Illustration 19

X Limited in a business combination, purchased the net assets of Y Limited for ₹ 4,00,000 on March 31, 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?

Solution

X Ltd. will account for the assets acquired from Y Ltd. 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:

$$\text{Goodwill} = ₹4,00,000 - ₹(1,50,000 + 70,000 + 30,000 + 1,30,000 - 50,000) = ₹70,000.$$

Illustration 20

X Ltd. acquired Y Ltd. on April 30, 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?

Solution

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).

Illustration 21

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

Solution:

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).

Illustration 22

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?

Solution

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.

Illustration 23

An entity is developing a new production process. During 20X1-20X2, expenditure incurred was ₹1,000, of which ₹900 was incurred before March 1, 20X2 and ₹100 was incurred between March 1, 20X2 and March 31, 20X2. The entity is able to demonstrate that at March 1, 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.

Explain the accounting treatment of expenditure incurred in 20X1-20X2 and 20X2-20X3 as per relevant Ind AS.

Solution

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., March 1, 20X2). ₹900 expenditure incurred before March 1, 20X2 is recognised as an expense because the recognition criteria were not met until March 1, 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.

Illustration 24 - (MTP – Oct 2020)

X Ltd. is engaged in developing computer software. The expenditures incurred by X Ltd. in pursuance of its development of software is given below:

- Paid ₹2,00,000 towards salaries of the program designers.
- Incurred ₹5,00,000 towards other cost of completion of program design.
- Incurred ₹2,00,000 towards cost of coding and establishing technical feasibility.
- Paid ₹7,00,000 for other direct cost after establishment of technical feasibility.
- Incurred ₹2,00,000 towards other testing costs.
- 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.

On March 15, 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?

Solution

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.

Illustration 25

X Ltd. has started developing a new production process in financial year 20X1-20X2. Total expenditure incurred till September 30, 20X1, was ₹1,00,00,000. The expenditure on the development of the production process meets the recognition criteria on July 1, 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?

Solution

X Ltd. should recognise the intangible asset at ₹70,00,000 and ₹30,00,000 which was already recognized as an expense in first quarter should not be capitalised.

Illustration 26

X Ltd. decides to revalue its intangible assets on April 1, 20X1. On the date of revaluation, the intangible assets stand at a cost of ₹1,00,00,000 and accumulated amortization 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?

Solution

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.

Alternatively, the net block can be increased by ₹ 90,00,000

Illustration 27 - (RTP May'20)

One of the senior engineers at XYZ has been working on a process to improve manufacturing efficiency and, consequently, reduce manufacturing costs. This is a major project and has the full support of XYZ's board of directors. The senior engineer believes that the cost reductions will exceed the project costs within twenty four months of their implementation. Regulatory testing and health and safety approval was obtained on 1 June 20X5. This removed uncertainties concerning the project, which was finally completed on 20 April 20X6. Costs of ₹ 18,00,000, incurred during the year till 31st March 20X6, have been recognized as an intangible asset. An offer of ₹ 7,80,000 for the new developed technology has been received by potential buyer but it has been rejected by XYZ. Utkarsh believes that the project will be a major success and has the potential to save the company ₹ 12,00,000 in perpetuity. Director of research at XYZ, Neha, who is a qualified electronic engineer, is seriously concerned about the long term prospects of the new process and she is of the opinion that competitors would have developed new technology at some time which would require to replace the new process within four years. She estimates that the present value of future cost savings will be ₹ 9,60,000 over this period. After that, she thinks that there is no certainty about its future. What would be the appropriate accounting treatment of aforesaid issue?

Solution

Ind AS 38 'Intangible Assets' requires an intangible asset to be recognised if, and only if, certain criteria are met. Regulatory approval on 1 June 20X5 was the last criterion to be met, the other criteria have been met as follows:

- Intention to complete the asset is apparent as it is a major project with full support from board
- Finance is available as resources are focused on project
- Costs can be reliably measured
- Benefits are expected to exceed costs – (in 2 years)

Since the project was completed on 20th April, 20X6, on 31st March, 20X6, the amount of ₹ 15,00,000 (₹ 18,00,000 x 10/12) should be capitalised in the Balance sheet of year ending 20X5-20X6 representing expenditure since 1 June 20X5.

The expenditure incurred prior to 1 June 20X5 which is ₹ 3,00,000 (2/12 x ₹ 18,00,000) should be recognised as an expense, retrospective recognition of expense as an asset is not allowed.

Ind AS 36 'Impairment of assets' requires an intangible asset not yet available for use to be tested for impairment annually.

Cash flow of ₹ 12,00,000 in perpetuity would clearly have a present value in excess of ₹ 12,00,000 and hence there would be no impairment. However, the research director is technically qualified, so impairment tests should be based on her estimate of a four-year remaining life and so present value of the future cost savings of ₹ 9,60,000 should be considered in that case. ₹ 9,60,000 is greater than the offer received (fair value less costs to sell) of ₹ 7,80,000 and so ₹ 9,60,000 should be used as the recoverable amount.

So, the carrying amount should be consequently reduced to ₹ 9,60,000.

Calculation of Impairment loss:

Particulars	Amount ₹
Carrying amount (Restated)	15,00,000

Less: Recoverable amount *	<u>9,60,000</u>
Impairment loss	<u>5,40,000</u>

Impairment loss of ₹ 5,40,000 is to be recognised in the profit and loss for the year 20X5-20X6.

Necessary adjusting entry to correct books of account will be:

	₹	₹
Operating expenses- Development expenditure Dr.	3,00,000	8,40,000
Operating expenses—Impairment loss of intangible assets Dr.	5,40,000	
To Intangible assets – Development expenditure		

Question 1 (RTP Nov'20)

ABC Pvt. Ltd., recruited a player. As per the terms of the contract, the player is prohibited from playing for any other entity for coming 5 years and have to in the employment with the company and cannot leave the entity without mutual agreement. The price the entity paid to acquire this right is derived from the skills and fame of the said player. The entity uses and develops the player through participation in matches. State whether the cost incurred to obtain the right regarding the player can be recognised as an intangible asset as per Ind AS 38?

Solution:

As per Ind AS 38, for an item to be recognised as an intangible asset, it must meet the definition of an intangible asset, i.e., identifiability, control over a resource and existence of future economic benefits and also recognition criteria.

With regard to establishment of control, paragraph 13 of Ind AS 38 states that 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.

Further, paragraph 15 of Ind AS 38 provides that 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.

Since the right in the instant case is contractual, identifiability criterion is satisfied. Based on the facts provided in the given case, the player is prohibited from playing in other teams by the terms of the contract which legally binds the player to stay with ABC Ltd for 5 years.

Accordingly, in the given case, the company would be able to demonstrate control. Future economic benefits are expected to arise from use of the player in matches. Further, cost of obtaining rights is also reliably measurable. Hence, it can recognise the costs incurred to obtain the right regarding the player as an intangible asset. However, careful assessment of relevant facts and circumstances of each case is required to be made.

Question 2 (RTP May'21)

PQR Ltd. is a gaming developer company. Few years back, it developed a new game called 'Cloud9'. This game sold over 10,00,000 copies around the world and was extremely profitable. Due to its popularity, PQR Ltd. released a new game in the 'Cloud9' series every year. The games continue to be the bestseller. Based on Management's expectations, estimates of cash flow projections for the 'cloud9 videogame series' over the next five years have been prepared. Based on these projections, PQR Ltd. believes that cloud9 series brand should be recognised at INR 20,00,000 in its financial statement. PQR Ltd. has also paid INR 10,00,000 to MNC Ltd. to acquire rights of another video game series called the 'Headspace' videogame series. The said series have huge demand in the market.

Discuss the accounting treatment of the above in the financial statements of PQR Ltd.

Solution:

In order to determine the accounting treatment of 'cloud9 videogame series' and 'Headspace', definition of asset and intangible asset given in Ind AS 38 may be noted:

"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."

"An intangible asset is an identifiable non-monetary asset without physical substance."

In accordance with the above, for recognising an intangible asset, an entity must be able to demonstrate that the item satisfies the criteria of identifiability, control and existence of future economic benefits.

In order to determine whether 'cloud9 videogame series' meet the aforesaid conditions, following provisions of Ind AS 38 regarding Internally Generated Intangible Assets may be noted:

As per paragraph 63 and 64 of Ind AS 38, internally generated brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognised as intangible assets. Expenditure on such items cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets.

Accordingly, though the cash flow projections suggest that the cloud9 brand will lead to future economic benefits, yet the asset has been internally generated; therefore, the Cloud9 brand cannot be recognised as intangible asset in the financial statements.

In order to determine whether 'Headspace' meet the aforesaid conditions, following provisions of Ind AS 38 regarding 'Separately acquired Intangible Assets' should be analysed.

As per paragraphs 25 and 26 of Ind AS 38, normally, the price an entity pays to acquire separately an intangible asset will reflect expectations 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 in paragraph 21(a) 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.

The Headspace game has been purchased for INR 10,00,000 and it is expected to generate future economic benefits to the entity. Since Headspace game is a separately acquired asset and the future benefits are expected to flow to the entity, therefore, an intangible asset should be recognised in respect of the 'Headspace' asset at its cost of INR 10,00,000. After initial recognition, either cost model or revaluation model can be used to measure headspace intangible asset as per guidance given in paragraphs 74-87 of Ind AS 38. In accordance with this, Headspace intangible asset should be carried at its cost/revalued amount (as the case may be) less any accumulated amortisation and any accumulated impairment losses.

Question 3 – (Past Exam May'21) (MTP Nov'22)

Super Sounds Limited had the following transactions during the Financial Year 2019-2020.

- (i) On 1st April 2019, Super Sounds Limited purchased the net assets of Music Limited for ₹ 13,20,000. The fair value of Music Limited's identifiable net assets was ₹ 10,00,000. Super Sounds Limited is of the view that due to popularity of Music Limited's product, the life of goodwill is 10 years.
- (ii) On 4th May 2019, Super Sounds Limited purchased a Franchisee to organize musical shows from Armaan TV for ₹ 80,00,000 and at an annual fee of 2% of musical shows revenue. The Franchisee expires after 5 years. Musical shows revenue were ₹ 10,00,000 for financial year 2019-2020. The projected future revenues for financial year 2020-2021 is ₹ 25,00,000 and ₹ 30,00,000 p.a. for remaining 3 years thereafter.
- (iii) On 4th July 2019, Super Sounds Limited was granted a Copyright that had been applied for by Music Limited. During financial year 2019-2020, Super Sound Limited incurred ₹ 2,50,000 on legal cost to register the Patent and ₹ 7,00,000 additional cost to successfully prosecute a copyright infringement suit against a competitor.

The life of the Copyright is for 10 years.

Super Sound Limited follows an accounting policy to amortize all intangible on SLM (Straight Line Method) basis or any appropriate basis over a maximum period permitted by relevant Ind AS, taking a full year amortization in the year of acquisition.

You are required to prepare:

- (i) A Schedule showing the intangible section in Super Sound Limited Balance Sheet as on 31st March 2020, and
- (ii) A Schedule showing the related expenses that would appear in the Statement of Profit and Loss of Super Sound Limited for the year ended 2019-2020. **(10 Marks)**

SOLUTION**(i) Super Sounds Limited**

Balance Sheet (Extract relating to intangible asset) as at 31st March 2020

	Note No.	₹
Assets		
(1) Non- current asset		
Intangible assets	1	69,45,000

(ii) Super Sounds Limited

Statement of Profit and Loss (Extract)

for the year ended 31st March 2020

	Note No.	₹
Revenue from Operations		<u>10,00,000</u>
Total Revenue		
Expenses:		
Amortization expenses	2	16,25,000
Other expenses	3	<u>7,20,000</u>
Total Expenses		

Notes to Accounts (Extract)

1. Intangible Assets

		Gross Block (Cost)			Accumulated amortisation			Net block	
		Openi ng balan ce ₹	Additions ₹	Closing Balance ₹	Openin g balanc e ₹	Addition s ₹	Closing Balance ₹	Ope ning balan ce ₹	Closing Balance ₹
1.	Goodwill* (W.N.1)	-	3,20,000	3,20,000	-	-	-	-	3,20,000
2.	Franchise* (W.N.2)	-	80,00,000	80,00,000	-	16,00,000	16,00,000	-	64,00,000
3.	Copyright (W.N.3)	-	<u>2,50,000</u>	<u>2,50,000</u>	-	<u>25,000</u>	<u>25,000</u>	-	<u>2,25,000</u>
		-			-			-	
		-	<u>85,70,000</u>	<u>85,70,000</u>	-	<u>16,25,000</u>	<u>16,25,000</u>	-	<u>69,45,000</u>
		-			-			-	

*As per Ind AS 36, irrespective of whether there is any indication of impairment, an entity shall test goodwill acquired in a business combination for impairment annually. This implies that goodwill is not amortised annually but is subject to annual impairment, if any.

**As per the information in the question, the limiting factor in the contract for the use is time i.e., 5 years and not the fixed total amount of revenue to be generated. Therefore, an amortisation method that is based on the revenue generated by an activity that includes the use of an intangible asset is inappropriate and amortisation based on time can only be applied.

2.	Amortization expenses		
	Franchise (W.N.2)	16,00,000	
	Copyright (W.N.3)	<u>25,000</u>	16,25,000

3.	Other expenses		
	Legal cost on copyright	7,00,000	
	Fee for Franchise (10,00,000 x 2%)	20,000	
			7,20,000

Working Notes:

		₹
1)	Goodwill on acquisition of business	
	Cash paid for acquiring the business	13,20,000
	Less: Fair value of net assets acquired	(10,00,000)
	Goodwill	<u>3,20,000</u>
2)	Franchise	80,00,000
	Less: Amortisation (over 5 years)	(16,00,000)
	Balance to be shown in the balance sheet	<u>64,00,000</u>
(3)	Copyright	2,50,000
	Less: Amortisation (over 10 years as per SLM)	<u>(25,000)</u>
	Balance to be shown in the balance sheet	<u>2,25,000</u>

Question 4 (RTP May'22)

D Ltd. a leading publishing house, purchased copyright of a book from its author for publishing the same. As per the terms of the contract, if D Ltd. chooses to make the payment upfront then, copyright consideration of ₹ 80,00,000 is to be paid (which is in line with general practice in such arrangements). However, the contract also provided that, in case D Ltd. chooses to pay the consideration after 2 years, then it will be required to pay ₹ 1,00,00,000. At what value should the intangible asset be recognised as per Ind AS 38?

Solution:

As per paragraph 32 of Ind AS 38, "If payment for an intangible asset is deferred beyond normal credit terms, its cost is the cash price equivalent. The difference between this amount and the total payments is recognized as interest expense over the period of credit unless it is capitalized in accordance with Ind AS 23, Borrowing Costs."

In the given case, if the payment for an intangible asset i.e. copyright is deferred beyond normal credit terms, the cash price equivalent ₹ 80,00,000 should be considered as its cost and the intangible asset will be recorded initially at this value.

The difference of ₹ 20,00,000 between cash price equivalent (i.e. ₹ 80,00,000) and the total payment (i.e. ₹ 1,00,00,000) should be recognised as interest expense over the period of credit (i.e. 2 years in this case), unless it is eligible for capitalisation in accordance with Ind AS 23, Borrowing Costs

Question 5 (RTP Nov'22)

An entity has an intangible asset in the form of a product protected by patented technology which is expected to be a source of net cash inflows for at least 15 years. It has been recognised in the books on initial date at ₹ 12,00,000. 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. Company is amortising the asset in 15 years considering its residual value to be Zero. Annual amortization charged to Profit and Loss is ₹ 80,000. State, whether the accounting treatment done by the Company is in accordance with Ind AS 38? If not, then calculate the annual amortization of the intangible asset and also the amount at which it will be reflected in the balance sheet.

Solution:

For determination of amortisation of the intangible asset, which has finite useful life, two elements need to be determined: useful life and residual value.

Useful life is defined as:

- (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.

In the instant case, since the entity expects that the asset will be available for use by it for the period of 5 years and thereafter it will be transferred, the useful life of the asset is 5 years.

For residual value, paragraphs 100-102 of Ind AS 38 states that the residual value of an intangible asset with a finite useful life shall 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 depreciable amount of an asset with a finite useful life is determined after deducting its residual value. A residual value other than zero implies that an entity expects to dispose of the intangible asset before the end of its economic life.

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.

On application of above paragraphs, the depreciable amount of the patent will be determined after deducting the residual value, which is 60 % of its fair value at the date of its acquisition. Accordingly, the patent will be amortised over its useful life of 5 years, with a residual value equal to 60% of its fair value at the date of its acquisition. The patent will also be reviewed for impairment in accordance with Ind AS 36. Therefore, the accounting policy of amortising the asset over a period of 15 years considering its residual value of Zero is not in accordance with Ind AS 38.

Computation of correct amount of residual value and annual amortization

		₹
Cost of Intangible asset		12,00,000
Residual value	(60% of ₹ 12,00,000)	7,20,000
Depreciable value of intangible asset	(12,00,000 – 7,20,000)	4,80,000
Useful life		5 years
Annual amortisation	(4,80,000 / 5)	₹ 96,000 p.a.

Question 6 (RTP May 23)

An entity acquired two trade secrets (secret recipes) in a business combination. Recipe A is patented. Recipe B is not legally protected.

How the acquisition of Recipe A and Recipe B would be accounted for by the entity as per relevant Ind AS.

Solution:

Para 11 and 12 of Ind AS 38 states that the definition of an intangible asset requires an intangible asset to be identifiable to distinguish it from goodwill. Goodwill recognized 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.

Further, 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. In the given case, Recipe A meets the contractual-legal criterion for identification as an intangible asset because it is protected by a patent.

This recipe is identified and recognised separately from goodwill while accounting the business combination.

Since Recipe B is not protected by a patent, it does not meet the contractual-legal criterion for identification as an intangible asset. However, Recipe B is identified as a separate intangible asset because it meets the separability criterion. Such recipes can be, and often are, exchanged, licensed or leased to others. Therefore, the unpatented Recipe B should be accounted for as a separate intangible asset acquired in the business combination.

Question 7 (RTP Nov'23)

A company engaged in the provision of Information Technology Products and Services incurred following expenditure during the development phase of its software product that is to be offered to its customers. The entity also purchases software from third parties for incorporating into its end software product offered to its customers. The company is in the process of launching it in the market for licensing to customers. The company also takes services of external professional software developers for such software development purpose. Costs incurred in relation to the development of its software product for the year ended 31st March, 20X2 are as follows:

Particulars	Amount (₹ thousands)
Purchase price of imported software	600
Employment costs (Note 1)	1,200
Testing costs	1,800
Other costs directly related to customization (Note 2)	450
Professional fees paid for external software developers	220
Costs of training provided to staff to operate the asset	195
Costs of advertising in market	1,560
Administrative and general overheads	825

Note 1: The software was developed in nine months ended 31st December, 20X1 and was capable of operating in the manner intended by the entity. It was brought into use on 31st March, 20X2. The employment costs are for the period of twelve months (i.e. up to 31st March, 20X2). The employees were engaged in developing the software and related activities.

Note 2: Other costs directly related to development include an abnormal cost of ₹ 50,000 in respect of repairing the damage which resulted from a security breach. What will be the amount of the software development costs that can be capitalized by explaining the reason for each element of cost?

Solution:

In the given fact pattern, the entity should apply the recognition and measurement principles relevant for an internally generated intangible asset. The entity has to ensure compliance with additional requirements relating to internally generated intangible assets in addition to general recognition criteria and initial measurement of intangible asset. In the instant case, for the measurement of software development cost, entity must evaluate the costs incurred for recognition of an intangible asset arising from development phase with reference to paragraphs 65 to 67 of Ind AS 38.

According to the said paragraphs, the initial carrying amount of the software will be computed as follows:

Particulars	Amount (₹ in thousands)	Amount to be capitalised as Intangible Assets (₹ in	Remarks

		thousands)	
Purchase price of imported software	600	600	The cost of materials or / and services used or consumed in generating the intangible asset and any directly attributable cost of preparing the asset for its intended use.
Employment costs (Note 1)	1,200	900	Employment costs for the period of nine months are directly attributable costs. Therefore, the cost to be capitalized is ₹ 900 thousand (i.e., $9/12 \times ₹ 1,200$ thousand) for nine months as the asset was ready for its intended use by that time. It is assumed that ₹ 100 thousand is equally incurred each month. Capitalisation of eligible costs should cease when the asset is capable of operating in the manner intended by management.
Testing costs	1,800	1,800	The cost of testing whether the asset is functioning properly is a directly attributable cost. (Refer paragraph 59 of Ind AS 38)
Other costs directly related to development (Note 2)	450	400	Cost of identified inefficiencies deducted, i.e., ₹ 450 thousand – ₹ 50 thousand.
Professional fees paid for bringing the software to its working condition	220	220	The cost of materials or/and services used or consumed in generating the intangible asset
Costs of training provided to staff	195	Nil	Expenditure on training staff to operate the asset cannot be capitalised. (Refer paragraph 67 of Ind AS 38)
Costs of advertising in market	1,560	Nil	Selling, administrative and other general overhead expenditure cannot be capitalised. (Refer paragraph 67 of Ind AS 38)
Administrative and general overheads	825	Nil	
Total	6,850	3,920	

Accordingly, the initial carrying value of the software is ₹ 39,20,000. The remaining costs will be charged to profit or loss.

IND AS 40 – INVESTMENT PROPERTY

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.

Illustration 2

Netravati Ltd. purchased a commercial office space as an Investment Property, in the Global Trade Centre Commercial Complex, for ₹ 5 crores. However, for purchasing the same, the Company had to obtain membership of the Global Trade Centre Commercial Complex Association by paying ₹ 6,25,000 as a one-time joining fee. Netravati Ltd. wants to write off the one-time joining fees paid as an expense under Membership and Subscription Charges and value the investment property at ₹ 5 crores. Advise.

Would you answer change if the office space was purchased with the intention of using it as an administrative centre of the company?

Solution:

Cost of Investment Property

As per Ind AS 40, 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). Accordingly, on initial recognition, the one-time joining fee of ₹ 6,25,000 should be added to the purchase price. Therefore, the investment property should be measured at ₹ 5,06,25,000 (i.e. cost of the commercial office space + one-time joining fee). Writing off the amount of ₹ 6,25,000 to the P&L is not appropriate.

Use as Administrative Office

If the property is used as an administrative centre, it is not an investment property, but rather an 'owner occupied property'. Hence, Ind AS 16 will be applicable.

Even under Ind AS 16, all direct costs relating to the acquisition of the asset should be added to the purchase price. Hence, cost of the asset under Ind AS 16 would be ₹ 5,06,25,000.

Illustration 3

X Limited purchased a building for ₹ 30,00,000 on 1st May, 20X1 with an intention to earn rentals. The purchase price was funded by a loan, interest on which is payable @ 5%. Property transfer taxes and direct legal costs of ₹ 1,00,000 and ₹ 20,000 respectively were incurred in acquiring the building. X Limited redeveloped the building into retail shops for rent under operating leases to independent third parties. Expenditures on redevelopment were:

- a) ₹ 2,00,000 planning permission.

b) ₹ 7,00,000 construction costs (including ₹ 40,000 refundable purchase taxes)

The building does not qualify the substantial period criteria for redevelopment of property under Ind AS 23. What is the cost of the Building as per Ind AS 40?

Solution:

As per Ind AS 40, 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).

Accordingly, cost of the Building is arrived at as under:

Particulars	Amount in ₹	Total ₹
Purchase price		30,00,000
Add: Property transfer taxes		1,00,000
Direct legal costs		20,000
Fee for planning permission		2,00,000
Construction costs	7,00,000	
Less: Refundable purchase taxes	40,000	6,60,000
Cost of the Building as per Ind AS 40		39,80,000

Note: The building does not qualify the substantial period criteria for redevelopment of property. Hence, borrowing cost of loan fund has not been capitalised.

Illustration 4

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.

Illustration 5

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. Determine the value of the building on reclassification as 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

Illustration 6

On April 1, 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 March 31, 20X2?

Solution

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

$$= ₹(40,00,000 - 1,90,000) = ₹38,10,000.$$

Illustration 7

X Limited has an investment property (building) which is carried in Balance Sheet on March 31, 20X1 at ₹15,00,000. During the year, X Limited has stopped letting out the building and used it as its office premise. On March 31, 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 March 31, 20X1?

Solution

At March 31, 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 March 31, 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.

Illustration 8

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 April 1, 20X1 - Purchase cost of the property ₹1,80,00,000.

On April 1, 20X1 - Non-refundable transfer taxes ₹20,00,000 (not included in the purchase cost).

On April 2, 20X1- Legal cost related to property acquisition ₹5,00,000.

On April 6, 20X1- Advertisement campaign to attract tenants ₹3,00,000.

On April 8, 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?

Solution

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 × 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.

Illustration 9 (RTP – Nov 2018)

X Ltd. is engaged in the construction industry and prepares its financial statements up to 31st March each year. On 1st April, 20X1, X Ltd. purchased a large property (consisting of land) for ₹ 2,00,00,000 and immediately began to lease the property to Y Ltd. on an operating lease. Annual rentals were ₹ 20,00,000. On 31st March, 20X5, the fair value of the property was ₹ 2,60,00,000. Under the terms of the lease, Y Ltd. was able to cancel the lease by giving six months' notice in writing to X Ltd. Y Ltd. gave this notice on 31st March, 20X5 and vacated the property on 30th September, 20X5. On 30th September, 20X5, the fair value of the property was ₹ 2,90,00,000. On 1st October, 20X5, X Ltd. immediately began to convert the property into ten separate flats of equal size which X Ltd. intended to sell in the ordinary course of its business. X Ltd. spent a total of ₹ 60,00,000 on this conversion project between 30th September, 20X5 to 31st March, 20X6. The project was incomplete at 31st March, 20X6 and the directors of X Ltd. estimate that they need to spend a further ₹ 40,00,000 to complete the project, after which each flat could be sold for ₹ 50,00,000.

Examine and show how the three events would be reported in the financial statements of X Ltd. for the year ended 31st March, 20X6 as per Ind AS.

Solution:

From 1st April, 20X1, the property would be regarded as an investment property since it is being held for its investment potential rather than being owner occupied or developed for sale.

The property would be measured under the cost model. This means it will be measured at ₹ 2,00,00,000 at each year end.

On 30th September, 20X5, the property ceases to be an investment property. X Ltd. begins to develop it for sale as flats.

As per para 59 of Ind AS 40, transfers between investment property, owner-occupied property and inventories do not change the carrying amount of the property transferred and they do not change the cost of that property for measurement or disclosure purposes. Hence, the carrying value of the reclassified property will be ₹ 2,00,00,000.

Since the lease of the property is an operating lease, rental income of ₹ 10,00,000 (₹ 20,00,000 × 6/12) would be recognised in P/L for the year ended 31st March, 20X6.

The additional costs of ₹ 60,00,000 for developing the flats which were incurred up to and including 31st March, 20X6 would be added to the 'cost' of inventory to give a closing cost of ₹ 2,60,00,000.

The total selling price of the flats is expected to be ₹ 5,00,00,000 (10 × ₹ 50,00,000). Since the further costs to develop the flats total ₹ 40,00,000, their net realisable value is ₹ 4,60,00,000 (₹ 5,00,00,000 – ₹ 40,00,000), so the flats will be measured at a cost of ₹ 2,60,00,000.

The flats will be shown in inventory as a current asset.

Illustration 10 - (RTP Nov'20, MTP March'21)

Shaurya Limited owns Building A which is specifically used for the purpose of earning rentals. The Company has not been using the building A or any of its facilities for its own use for a long time. The company is also exploring the opportunities to sell the building if it gets the reasonable amount in consideration.

Following information is relevant for Building A for the year ending 31st March, 2020:

Building A was initially purchased at the cost of ₹ 10 crores. At that time, the useful life of the building was estimated to be 20 years; out of which 5 years have been expired as on 1st April, 2019. The company follows straight line method for depreciation.

During the year, the company has invested in another Building B with the purpose to hold it for capital appreciation. The property was purchased on 1st April, 2019 at the cost of ₹ 2 crore. Expected life of the building is 40 years. As usual, the company follows straight line method of depreciation.

Further, during the year 2019-2020, the company earned / incurred following direct operating expenditure relating to Building A and Building B:

Rental income from Building A	=	₹ 75 lakh
Rental income from Building B	=	₹ 25 lakh
Sales promotion expenses	=	₹ 5 lakh
Fees & Taxes	=	₹ 1 lakh
Ground rent	=	₹ 2.5 lakh
Repairs & Maintenance	=	₹ 1.5 lakh
Legal & Professional	=	₹ 2 lakh
Commission and brokerage	=	₹ 1 lakh

The company does not have any restrictions and contractual obligations against buildings - A and B. For complying with the requirements of Ind AS, the management sought an independent report from the specialists so as to ascertain the fair value of buildings A and B. The independent valuer has valued the fair value of property as per the valuation model recommended by International valuation standards committee. Fair value has been computed by the method by streamlining present value of future cash flows namely, discounted cash flow method.

The other key inputs for valuation are as follows:

The estimated rent per month per square feet for the period is expected to be in the range of ₹ 50 - ₹ 60. It is further expected to grow at the rate of 10 percent per annum for each of 3 years. The weighted discount rate used is 12% to 13%.

Assume that the fair value of properties based on discounted cash flow method is measured at ₹ 10.50 crore on 31st March, 2020. The treatment of fair value of properties is to be given in the financials as per the requirements of Indian accounting standards.

What would be the treatment of Building A and Building B in the balance sheet of Shaurya Limited? Provide detailed disclosures and computations in line with relevant Indian accounting standards. Treat it as if you are preparing a separate note or schedule, of the given assets in the balance sheet. **(8 Marks)**

Solution:

Investment property is held to earn rentals or for capital appreciation or both. Ind AS 40 shall be applied in the recognition, measurement and disclosure of investment property. An investment property shall be measured initially at its cost. After initial recognition, an entity shall measure all of its investment properties in accordance with the requirement of Ind AS 16 for cost model.

The measurement and disclosure of Investment property as per Ind AS 40 in the balance sheet would be depicted as follows:

INVESTMENT PROPERTIES:

Particulars	Period ended 31st March, 2020 (₹ in crore)
Gross Amount:	
Opening balance (A)	10.00
Additions during the year (B)	<u>2.00</u>
Closing balance (C) = (A) + (B)	<u>12.00</u>
Depreciation:	
Opening balance (D)	2.50
Depreciation during the year (E) (0.5 + 0.05)	<u>0.55</u>
Closing balance (F) = (D) + (E)	<u>3.05</u>
Net balance (C) - (F)	<u>8.95</u>

The changes in the carrying value of investment properties for the year ended 31st March, 2020 are as follows:

Amount recognised in Profit and Loss with respect to Investment Properties

Particulars	Period ending 31st March, 2020 (₹ in crore)
Rental income from investment properties (0.75 + 0.25)	1.00
Less: Direct operating expenses generating rental income (5+1+2.5+1.5+2+1)	<u>(0.13)</u>
Profit from investment properties before depreciation and indirect expenses	0.87
Less: Depreciation	<u>(0.55)</u>
Profit from earnings from investment properties before indirect expenses	<u>0.32</u>

Disclosure Note on Investment Properties acquired by the entity

The investment properties consist Property A and Property B. As at 31st March, 2020, the fair value of the properties is ₹10.50 crore. The valuation is performed by independent valuers, who are specialists in valuing investment properties. A valuation model as recommended by International Valuation Standards Committee has been applied. The Company considers factors like management intention, terms of rental agreements, area leased out, life of the assets etc. to determine classification of assets as investment properties.

The Company has no restrictions on the realisability of its investment properties and no contractual obligations to purchase, construct or develop investment properties or for repairs, maintenance and enhancements.

Description of valuation techniques used and key inputs to valuation on investment properties:

Valuation technique	Significant unobservable inputs	Range (Weighted average)
Discounted cash flow (DCF) method	- Estimated rental value per sq. ft. per month	₹ 50 to ₹ 60
	- Rent growth per annum	10% every 3 years
	- Discount rate	12% to 13%

Illustration 11 - (RTP May'21) (Past Exam May'22) (MTP May'23)

X Ltd owned a land property whose future use was not determined as at 31 March 20X1. How should the property be classified in the books of X Ltd as at 31 March 20X1?

During June 20X1, X Ltd commenced construction of office building on it for own use. Presuming that the construction of the office building will still be in progress as at 31 March 20X2

- (a) How should the land property be classified by X Ltd in its financial statements as at 31 March 20X2?
- (b) Will there be a change in the carrying amount of the property resulting from any change in use of the investment property?
- (c) Whether the change in classification to, or from, investment properties is a change in accounting policy to be accounted for in accordance with Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors?
- (d) Would your answer to (a) above be different if there were to be a management intention to commence construction of an office building for own use; however, no construction activity was planned by 31 March 20X2?
- (5 Marks)

Solution

As per paragraph 8(b) of Ind AS 40, any land held for currently undetermined future use, should be classified as an investment property. Hence, in this case, the land would be regarded as held for capital appreciation. Hence the land property should be classified by X Ltd as investment property in the financial statements as at 31 March 20X1.

As per Para 57 of the Standard, an entity can change the classification of any property to, and from, an investment property when and only when evidenced by a change in use. A change occurs when the property meets or ceases to meet the definition of investment property and there is evidence of the change in use. Mere management's intention for use of the property does not provide evidence of a change in use.

- (a) Since X Ltd has commenced construction of office building on it for own use, the property should be reclassified from investment property to owner occupied as at 31 March 20X2.
- (b) As per Para 59, transfers between investment property, owner occupied and inventories do not change the carrying amount of the property transferred and they do not change the cost of the property for measurement or disclosure purposes.
- (c) No. The change in classification to, or from, investment properties is due to change in use of the property. No retrospective application is required and prior period's financial statements need not be restated.
- (d) Mere management intentions for use of the property do not evidence change in use. Since X Ltd has no plans to commence construction of the office building during 20X1-20X2, the property should continue to be classified as an investment property by X Ltd. in its financial statements as at 31 March 20X2.

Question 1 - (MTP - AUG 2018)

UK Ltd. has purchased a new head office property for Rs.10 crores. The new office building has 10 floors and the organisation structure of UK Ltd. is as follows:

Floor	1st	2nd	3rd	4th	5th	6th	7th	8th	9th	10th
Use	Waiting Area	Admin	HR	Accounts	Inspection	MD Office	Canteen	Vacant		

Since UK Ltd. did not need the floors 8, 9 and 10 for its business needs, it has leased out the same to a restaurant on a long-term lease basis. The terms of the lease agreement are as follows:

- Tenure of Lease Agreement - 5 Years
- Non-Cancellable Period - 3 years
- Lease Rental-annual lease rental receivable from these floors are Rs. 10,00,000 per floor with an escalation of 5% every year.

Based on the certificate from its architect, UK Ltd. has estimated the cost of the 3 top floors as approximately Rs. 3 crores. The remaining cost of Rs. 7 crores can be allocated as 25% towards Land and 75% towards Building.

As on 31st March, 2018, UK Ltd. obtained a valuation report from an independent valuer who has estimated the fair value of the property at Rs. 15 crores. UK Ltd. wishes to use the cost model for measuring Property, Plant & Equipment and the fair value model for measuring the Investment Property. UK Ltd. depreciates the building over an estimated useful life of 50 years, with no estimated residual value.

Advise UK Ltd. on the accounting and disclosures for the above as per the applicable Ind AS.

Solution:

Ind AS 16 'Property, Plant and Equipment' states that property, plant and equipment are tangible items that are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

As per Ind AS 40 'Investment property', investment property is a property held to earn rentals or for capital appreciation or both, rather than for use in the production or supply of goods or services or for administrative purposes or sale in the ordinary course of business.

Further, as per para 8 of Ind AS 40, the building owned by the entity and leased out under one or more operating leases will be classified as investment property.

Here top three floors have been leased out for 5 years with a non-cancellable period of 3 years. The useful life of the building is 50 years. The lease period is far less than the useful life of the building leased out. Further, the lease rentals of three years altogether do not recover the fair value of the floors leased i.e. 15 crore x 30% = 4.50 crore. Hence the lease is an operating lease. Therefore, the 3 floors leased out as operating lease will be classified as investment property in the books of lessor i.e. UK Ltd.

However, for investment property, Ind AS 40 states that an entity shall adopt as its accounting policy the cost model to all of its investment property. Ind AS 40 also requires that an entity shall disclose the fair value of such investment property(ies).

	Total	PPE (70%)		Investment property (30%)
		Land (25%)	Building (75%)	
Cost	10	1.75	5.25	3
FV	15	2.625	7.875	4.5
Valuation model followed		Cost	Cost	Cost (as per para 30 of Ind AS 40)

Value recognized in the books		1.75	5.25	3
Less: Depreciation		Nil	(5.25/50) = 0.105 crore	(3/50) = 0.06
Carrying value as on 31 st March, 2018		1.75	5.145	2.94

Question 2 (Past Exam May'18, July'21) (MTP May'23)

Stars Ltd. is a multinational entity that owns three properties. All the three properties were purchased on 1st April 2016. The details of purchase price and the market values of the properties are given as follows:

Particulars	Property 1	Property 2	Property 3
	Factory	Factory	Let-out Building
Purchase Price	30,000	20,000	24,000
Market Value (31-03-2017)	32,000	22,000	27,000
Life	10 years	10 years	10 years
Subsequent Measurement	Cost Model	Revaluation Model	Revaluation Model

Property 1 and 2 are occupied by Stars Ltd, 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.

Analyze whether the accounting policies adopted by the Company in relation to the given properties are in accordance with Ind AS. If not, advise the correct treatment and present an extract of the Balance Sheet.

(8 Marks)**Solution****(i) For classification of assets**

As per Ind AS 16 'Property, Plant and Equipment' states that Property, plant and equipment are tangible items that are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

As per Ind AS 40 'Investment property', investment property is a property held to earn rentals or for capital appreciation or both, rather than for use in the production or supply of goods or services or for administrative purposes; or sale in the ordinary course of business.

According to the facts given in the questions, since Property 1 and 2 are used as factory buildings, their classification as PPE is correct. However, Property 3 is held to earn rentals; hence, it should be classified as Investment Property. Thus, its classification as PPE is not correct. Property 3 shall be presented as separate line item as Investment Property as per Ind AS 1.

(ii) For valuation of assets

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. Also, 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.

However, for investment property, Ind AS 40 states that an entity shall adopt as its accounting policy the cost model to all of its investment property. Ind AS 40 also requires that an entity shall disclose the fair value of investment property.

Since property 1 and 2 is used as factory building, they should be classified under same category or class i.e. 'factory building'. Therefore, both the properties should be valued either at cost model or revaluation model. Hence, the valuation model adopted by Stars Ltd. is not consistent and correct as per Ind AS 16.

In respect to property 3 being classified as Investment Property, there is no alternative of revaluation model i.e. only cost model is permitted for subsequent measurement. However, Stars Ltd. is required to disclose the fair value of the investment property in the Notes to Accounts.

(iii) For changes in value on account of revaluation and treatment thereof

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 '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. Accordingly, the revaluation gain shall be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus.

(iv) For treatment of depreciation

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. Accordingly, Stars Ltd. is required to depreciate these properties irrespective of that their fair value exceeds the carrying amount.

(v) Rectified presentation in the balance sheet

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 should be as follows:

Case 1: If Stars Ltd. has applied the Cost Model to an entire class of property, plant and equipment.

Balance Sheet extracts as at 31st March 2017

Assets			
Non-Current Assets			
Property, Plant and Equipment			
Property 1 (30,000-3,000)	27,000		
Property 2 (20,000 – 2,000)	18,000		45,000

Investment Property		
Property 3 (Fair value being ₹ 27,000) (Cost = 24,000-2,400)		21,600

Case 2: If Stars Ltd. has applied the Revaluation Model to an entire class of property, plant and equipment.

Balance Sheet extracts as at 31st March 2017 ₹

Assets			
Non-current Assets			
Property, Plant and Equipment			
Property 1	32,000		
Property 2	22,000		54,000
Investment Properties			
Property 3 (Fair value being 27,000) (Cost = 24,000-2,400)			21,600
Equity and Liabilities			
Other Equity			
Revaluation Reserve *			

Property 1 (32,000 – 27,000)	5,000	
Property 2 (22,000 – 18,000)	4,000	9,000

Revaluation reserve should be routed through Other Comprehensive Income (OCI) (subsequently not reclassified to Profit and Loss) in the Statement of Profit and Loss and shown as a separate column in the Statement of Changes in Equity.

Question 3 (Past Exam Jan'21) (MTP April'22)

On 1st April 2019, an entity purchased an office block (building) for ₹ 50,00,000 and paid a non-refundable property transfer tax and direct legal cost of ₹ 2,50,000 and ₹ 50,000 respectively while acquiring the building.

During 2019, the entity redeveloped the building into two-story building. Expenditures on re-development were:

- ₹ 1,00,000 Building plan approval;
- ₹ 10,00,000 construction costs (including ₹ 60,000 refundable purchase taxes); and
- ₹ 40,000 due to abnormal wastage of material and labour.

When the re-development of the building was completed on 1st October 2019, the entity rents out Ground Floor of the building to its subsidiary under an operating lease in return for rental payment. The subsidiary uses the building as a retail outlet for its products. The entity kept first floor for its own administration and maintenance staff usage. Equal value can be attributed to each floor.

How will the entity account for all the above mentioned expenses in the books of account?

Also, discuss how the above building will be shown in Consolidated financial state ment of the entity as a group and in its separate financial statements as per relevant Ind AS.

(5 Marks)

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 building would be:

Particulars	Amount (₹)
Purchase amount	50,00,000
Non-refundable property tax	2,50,000
Direct legal cost	<u>50,000</u>
	53,00,000
Expenditures on redevelopment:	
Building plan approval	1,00,000
Construction costs (10,00,000 – 60,000)	<u>9,40,000</u>
Total amount to be capitalised at 1st October 2019	<u>63,40,000</u>

Treatment of abnormal wastage of material and labour:

As per Ind AS 16, 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. It will be charged to Profit and Loss in the year it is incurred. Hence, abnormal wastage of ₹ 40,000 will be expensed off in Profit & Loss in the financial year 2019 -2020.

Accounting of property- Building

When the property is used as an administrative centre, it is not an investment property, rather it is an 'owner occupied property'. Hence, Ind AS 16 will be applicable.

When the property (land and/or buildings) is held to earn rentals or for capital appreciation (or both), it is an investment property. Ind AS 40 prescribes the cost model for accounting of such investment property.

Since equal value can be attributed to each floor, Ground Floor of the building will be considered as Investment Property and accounted as per Ind AS 40 and First Floor would be considered as Property, Plant and Equipment and accounted as per Ind AS 16.

Cost of each floor = ₹ 63,40,000 / 2 = ₹ 31,70,000

As on 1st October 2019, the carrying value of building vis-à-vis its classification would be as follows:

- (i) In Separate Financial Statements: The Ground Floor of the building will be classified as investment property for ₹ 31,70,000, as it is property held to earn rentals. While First Floor of the building will be classified as item of property, plant and equipment for ₹ 31,70,000.
- (ii) In Consolidated Financial Statements: The consolidated financial statements present the parent and its subsidiary as a single entity. The consolidated entity uses the building for the supply of goods. Therefore, the leased-out property to a subsidiary does not qualify as investment property in the consolidated financial statements. Hence, the whole building will be classified as an item of Property, Plant and Equipment for ₹ 63,40,000.

Question 4 (RTP Nov'22)

An entity owns a two-storey building. Floor 1 is rented out to independent third parties under operating leases. Floor 2 is occupied by the entity's administration and maintenance staff. The entity can measure reliably the fair value of each floor of the building without undue cost or effort. How the same will be classified / presented in the balance sheet as per relevant Ind AS. What will be the accounting treatment as per relevant Ind AS on initial and subsequent date?

Solution:

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

Property mentioned in (a) above would be covered under Ind AS 16 'Property, Plant and Equipment'.

On applying the above provisions, Floor 1 of the building is classified as an item of investment property by the entity (lessor) because it is held to earn rentals. Ind AS 40 is applicable in this case. An investment property should be measured initially at its cost. After initial recognition, an entity shall measure all of its investment properties in accordance with Ind AS 16's requirements for cost model. However, 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.

Floor 2 of the building will be classified as property, plant and equipment because it is held by administrative staff i.e. it is held for use for administrative purposes. Ind AS 16 is applicable in this case. An item of property, plant and equipment that qualifies for recognition as an asset should be initially measured at its cost. After recognition, 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.

Question 5 (RTP Nov'23)

Besides manufacturing plants, A Ltd. has various other assets, not used for operational activities, e.g., freehold land, townships in different locations, excess of office space rented to ABC, etc. Also, A Ltd. has some land, which are kept vacant as per the government regulations which require that a specified area around the plant should be kept vacant.

The details of these assets are as under:

Property	Details
A Ltd.'s office building (registered office)	A Ltd.'s registered office in Delhi, is a 15 storey building, of which only 3 floors are occupied by A Ltd., whereas remaining floors are given on rent to other companies. These agreements are usually for a period of 3 years. According to A Ltd., such excess office space will continue to be let out on lease to external

	parties and have no plans to occupy it, at least in near future.
Flats in Township located in location 1	As regards township in Location 1, there are approximately 2,000 flats in the said township. It was built primarily for A Ltd.'s employees, hence, approximately 80% of the flats are allotted to employees and remaining flats are either kept vacant or given on rent to other external parties. A lease agreement is signed between A Ltd. and an individual party for every 12 months being 1st April to 31st March. The lease entered is a cancellable lease (cancellable at the option of any of the parties). Also, besides monthly rent, additional charges are levied by A Ltd. on account of electricity, water, cable connection, etc. According to A Ltd., there is no intention of selling such excess flats or allotting it to its employees.
Flats in township located in location 2	There are 1,000 flats in location 2 township, of which: - 400 flats are given to employees for their own accommodation. - 350 flats are given on rent to Central Government and State Government for accommodation of their employees. Average lease period being 12 months with cancellable clause in lease agreements. - 250 flats are kept vacant.
Hostel located in location 1	60 rooms in the hostel have been let out to G Ltd., to give accommodation to their personnel. Lease agreement is prepared for every 11 months and renewed thereafter. Besides the monthly rent amount, some charges are levied towards water, electricity and other amenities, e.g., cable connection, etc.
Land in location 1	In 20X4, A Ltd. purchased a plot of land on the outskirts of a major city. The area has mainly low-cost public housing and very limited public transport facilities. The government has plans to develop the area as an industrial park in 5 years' time and the land is expected to greatly appreciate in value if the government proceeds with the plan. A Ltd. has not decided what to do with the property.
Land in location 1	A portion of land has been leased out to C Ltd. for its manufacturing operations. Land has been given on lease on a lease rental of ₹ 10 lacs p.a. with a lease term of 25 years.
Land in location 2	A portion of the land has been given on rent to D Ltd. which has constructed a petrol pump on such land. It has been leased for a period of 40 years and renewed for a further period of 40 years.

Determine the classification of properties which are not held for operational purposes, with suitable reasoning in the financial statements of A Ltd.

Solution:

Property	Classification of properties not held for operational purpose
A Ltd.'s office building (registered office)	Excess portion of office space has been given on lease to earn rental income. Out of 15 storey building, only 3 floors are occupied by A Ltd. Such excess office space was constructed for the purpose of letting it out. According to A Ltd., such excess office space will continue to be let out on lease to external parties and have no plans to occupy it, at least in near future. Further, office space given on rent, although in same building, is separately identifiable from another owner-occupied portion and hence can be sold separately (if required). Hence, the excess space will qualify to be an investment property.
Flats in Township located in location 1	Excess flats have been given on lease to earn rental income. According to A Ltd., there is no intention of selling such excess flats or allotting it to its employees. Further, flats given on rent, can be sold separately from flats occupied by A Ltd.'s employees as they are separately identifiable. A Ltd. also

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	charges its lessees on account of ancillary services, i.e., water, electricity, cable connection, etc., but the monthly charges in such cases are generally not significant as compared to rental payments. Hence, flats given on rent should qualify to be an 'investment property'. With regards to the flats kept vacant, A Ltd. has to evaluate the purpose of holding these flats, i.e., whether these would be kept for earning rentals or will it be allotted to its future employees. In case they are held for earning rentals, it would be classified as an investment property; and if they are held for allotment to future employees, it would form part of property, plant and equipment.
Flats in township located in location 2	350 flats are given on lease to earn rental income and assuming that management intends to let out these flats on rent in future, such flats should be classified as an 'investment property'. With regards to the flats kept vacant, A Ltd. has to evaluate the purpose of holding these flats, i.e., whether these would be kept for earning rentals or will it be allotted to its future employees. In case they are held for earning rentals, it would be classified as an investment property; and if they are held for allotment to future employees, it would form part of property, plant and equipment.
Hostel located in location 1	Rooms in a hostel have been let out to G Ltd. to be used by its personnel. A Ltd. also charges G Ltd. on account of ancillary services, i.e., water, electricity, cable connection, etc., but the monthly charges in such cases are generally not significant as compared to rental payments. Hence, it should be classified as an 'Investment property'.
Land in location 1	Although management has not determined use for property after the development of park, yet in the medium-term the land is held for capital appreciation. As per Ind AS 40, if an entity has not determined that it will use the land either as owner-occupied property or for short term sale in the ordinary course of business, then it will be considered as land held for capital appreciation. Therefore, management should classify the property as an investment property.
Land in location 1	Since the land is held with an intention of giving it on lease and earning capital appreciation over a period, it should be classified as an 'Investment property'.
Land in location 2	Since the land is held with an intention of giving it on lease and earning capital appreciation over a period, it should be classified as 'Investment property'.

IND AS 41 – AGRICULTURE

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.

Vine 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.

Illustration 2 – (MTP – April, 2021)

A farmer owned a dairy herd, of three years old cattle as at April 1, 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 March 31, 20X2 was ₹ 60 per cattle. The fair value of four year cattle as at March 31, 20X2 is ₹75 per cattle.

Calculate the measurement of group of cattle as at March 31, 20X2 stating price and physical change separately. **(4 Marks)**

Solution

Particulars	Amount (₹)
Fair value as at April 1, 20X1	13,750
Increase due to Price change $[250 \times \{60 - (13,750/250)\}]$	1,250
Increase due to Physical change $[250 \times \{75-60\}]$	<u>3,750</u>
Fair value as at March 31, 20X2	<u>18,750</u>

At the end of reporting period 31st March 20X2

Biological Asset (Cattle A/c) Dr. 5,000

To Gain – Change in value (P/L A/c) 5,000

(Being change in value of Cattle recognised at the end of the reporting period)

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.

On date of Purchase

Biological Asset	Dr.	4,90,000
Expense on Purchase	Dr.	10,000
To Bank		5,00,000

(Being biological asset purchased)

On 31 March 20X4 sheep's 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.

At the end of reporting period

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)

Illustration 4 – (Past Exam – July 2021)

Moon Ltd prepares financial statements to 31 March each year. On 1 April 20 X1 the company carried out the following transactions:

- Purchased a land for ₹50 Lakhs.
- Purchased 200 dairy cows (average age at 1 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 31 March 20X2, the company has incurred following costs:

- ₹6 Lakhs to maintain the condition of the animals (food and protection).
- ₹4 Lakhs as breeding fee to a local farmer.

On 1 October 20X1, 100 calves were born. There were no other changes in the number of animals during the year ended 31 March 20X2. As of 31 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		
	1 April 20X1	1 October 20X1	31 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 (Assuming Land under Cost Method) and Statement of Profit & Loss that would be reflected in the financial statements of the entity for the year ended 31 March 20X2. Discuss the relevant Ind AS in support of your workings. (9 Marks)

Solution:

Extract from the Statement of Profit & Loss

Income	WN	Amount
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:	WN	Amount
Land	WN 1	50,00,000
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:

- 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.
- Dairy Cows:** Under the 'fair value model' laid down in IND AS 41 the mature cows would be recognised in the Balance Sheet at 31 March 20X2 at the fair value of $200 \times ₹ 5,500 = ₹ 11,00,000$.
 Increase in price change $200 \times (5,200 - 5,000) = 40,000$
 Increase in physical change $200 \times (5,500 - 5,200) = 60,000$

 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.
- Grant:** Grant 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.
- Calves:** They are a biological asset and the fair value model is applied. The breeding fees are charged to income and an asset of $100 \times ₹ 1,300 = ₹ 1,30,000$ 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 $3,000 \times ₹ 24 = ₹ 72,000$. This is regarded as 'cost' for the future application of IND AS 2 to the unsold milk.

Illustration 5 - (RTP Nov' 20, MTP Nov'21)

Entity A purchased cattle at an auction on 30th June 20X1.

Purchase price at 30 th June 20X1	₹ 1,00,000
Costs of transporting the cattle back to the entity's farm	₹ 1,000
Sales price of the cattle at 31 st March, 20X2	₹ 1,10,000

The company would have to incur similar transportation costs if it were to sell the cattle at auction, in addition to an auctioneer's fee of 2% of sales price. The auctioneer charges 2% of the selling price, from both, the buyer as well as the seller.

Calculate the amount at which cattle is to be recognised in books on initial recognition and at year end 31st March, 20X2. Show corresponding journal entries (4 Marks)

Solution

Initial recognition of cattle

	₹
Fair value less costs to sell ($₹ 1,00,000 - ₹ 1,000 - ₹ 2,000$)	97,000
Cash outflow ($₹ 1,00,000 + ₹ 1,000 + ₹ 2,000$)	1,03,000
Loss on initial recognition	6,000
Cattle Measurement at year end	
Fair value less costs to sell ($₹ 1,10,000 - 1,000 - (2\% \times 1,10,000)$)	1,06,800

At 31st March, 20X2, the cattle is measured at fair value of ₹ 1,09,000 less the estimated auctioneer's fee of ₹ 2,200. The estimated transportation costs of getting the cattle to the auction of ₹ 1,000 are deducted from the sales price in determining fair value.

Journal Entries on 30th June, 20X1

(All figures in ₹)

Biological Asset (Cattle A/c)	Dr.	97,000	
Loss on initial recognition	Dr.	6,000	
To Bank (Purchase and cost of transportation on purchase paid by buyer)			1,03,000
(Being biological asset purchased)			

Journal Entries on 31st March, 20X2

(All figures in ₹)

Biological Asset (Cattle A/c)	Dr.	9,800	
To Gain on remeasurement (P/L A/c)			9,800
(Subsequent measurement of cattle at fair value less costs to sell)			

Illustration 6 (Past Exam May'23)

XY Ltd. is a farming entity where cows are milked on a daily basis. Milk is kept in cold storage immediately after milking and sold to retail distributors on a weekly basis. On 1 April 20X1, XY Ltd. had a herd of 500 cows which were all three years old.

During the year, some of the cows became sick and on 30 September 20X1, 20 cows died. On 1 October 20X1, XY Ltd. purchased 20 replacement cows at the market for ₹ 21,000 each. These 20 cows were all one year old when they were purchased.

On 31 March 20X2, XY Ltd. had 1,000 litres of milk in cold storage which had not been sold to retail distributors. The market price of milk at 31 March 20X2 was ₹ 20 per litre. When selling the milk to distributors, XY Ltd. incurs selling costs of ₹ 1 per litre. These amounts did not change during March 20X2 and are not expected to change during April 20X2.

Information relating to fair value and costs to sell is given below:

	Fair value of a dairy cow (aged)				Costs to sell a cow
	1 year	1.5 years	3 years	4 years	
1st April 20X1	20,000	22,000	27,000	25,000	1,000
1st October 20X1	21,000	23,000	28,000	26,000	1,000
31st March 20X2	21,500	23,500	29,000	26,500	1,100

You can assume that fair value of a 3.5 years old cow on 1st October 20X1 is ₹ 27,000.

Pass necessary journal entries of above transactions with respect to cows in the financial statements of XY Ltd. for the year ended 31st March, 20X2? Also show the amount lying in inventory if any. (8 Marks)

Solution

Journal Entries on 1st October, 20X1

(All figures in ₹)

Loss (on death of 20 cows) (Refer W.N.)	Dr.	5,20,000	
To Biological asset			5,20,000
(Loss booked on death of 20 cows)			
Biological Asset (purchase of 20 new cows) (Refer W.N.)	Dr.	4,00,000	
Loss on initial recognition (of 20 new cows)	Dr.	20,000	
To Bank			4,20,000
(Initial recognition of 20 new purchased cows at fair value less costs to sell)			

Journal Entries on 31st March, 20X2

Loss on remeasurement of old cows	Dr.	2,88,000	
To Biological asset [(1,30,00,000 – 5,20,000) – 1,21,92,000]			2,88,000
(Subsequent measurement of cows at fair value less costs to sell)			
Biological Asset (4,48,000 – 4,00,000)	Dr.	48,000	
To Gain on remeasurement of new cows			48,000
(Subsequent measurement of cows at fair value less costs to sell)			

Inventory (Milk) as at 31st March, 20X2 = ₹ 19,000 (1,000 × (20 – 1))

Working Note:**Calculation of Biological asset at various dates**

Date	Number	Age	Fair Value (₹)	Cost to Sell (₹)	Net (₹)	Biological asset (₹)
1st April 20X1	500	3 years	27,000	1,000	26,000	1,30,00,000
1st October 20X1	(20)	3.5 years	27,000	1,000	26,000	(5,20,000)
1st October 20X1	20	1 year	21,000	1,000	20,000	4,00,000
						1,28,80,000
31st March 20X2	480	4 years	26,500	1,100	25,400	1,21,92,000
	20	1.5 years	23,500	1,100	22,400	4,48,000
						1,26,40,000

Illustration 7

Company X purchased 100 goat at an auction for ₹ 1,00,000 on 30 September 20X1. Subsequent transportation costs were ₹ 1,000 that is similar to the cost X would have to incur to sell the goat at the auction. Additionally, there would be a 2% selling fee on the market price of the goat to be incurred by the seller.

On 31 March 20X2, the market value of the goat in the most relevant market increases to ₹ 1,10,000. Transportation costs of ₹ 1,000 would have to be incurred by the seller to get the goat to the relevant market. An auctioneer's fee of 2% on the market price of the goat would be payable by the seller.

On 1 June 20X2, X sold 18 goat for ₹ 20,000 and incurred transportation charges of ₹ 150. In addition, there was a 2% auctioneer's fee on the market price of the goat paid by the seller.

On 15 September 20X2, the fair value of the remaining goat was ₹ 82,820. 42 goat were slaughtered on that day, with a total slaughter cost of ₹ 4,200. The total market price of the carcasses on that day was ₹ 48,300, and the expected transportation cost to sell the carcasses is ₹ 420. No other costs are expected.

On 30 September 20X2, the market price of the remaining 40 goat was ₹ 44,800. The expected transportation cost is ₹ 400. Also, there would be a 2% auctioneer's fee on the market price of the goat payable by the seller.

Pass Journal entries so as to provide the initial and subsequent measurement for all above transactions. Interim reporting periods are of 30 September and 31 March and the company determines the fair values on these dates for reporting.

Solution

Value of goat at initial recognition (30 September 20X1) (All figures are in ₹)

Biological asset (goat)	Dr.	97,000*	1,01,000
Loss on initial recognition	Dr.	4,000	
To Bank (Purchase and cost of transportation)			
(Initial recognition of goat at fair value less costs to sell)			

*Fair value of goat = 1,00,000 – 1,000 – 2,000 (2% of 1,00,000) = 97,000

Subsequent measurement at 31 March 20X2 (All figures are in ₹)

Biological Assets (Goat)	Dr.	9,800	9,800
To Gain on Sale (Profit & Loss)			

(Subsequent measurement of Goat at fair value less costs to sell
(1,06,800** – 97,000))

** Fair value of goat = 1,10,0000 – 1,000 – 2,200 (2% of 1,10,000) = 1,06,800

Sale of goat on 1 June 20X2 (All figures are in ₹)

Biological Assets (Goat)	Dr.	226	
To Gain on Sale (Profit & Loss)			226
(Subsequent re-measurement of 18 Goat at fair value less costs to sell just prior to the point at which they are sold [19,450 - {(1,06,800/100) x 18}])			
Cost to Sales	Dr.	19,450	
To Biological Assets (Goat)			19,450
(Recording a cost of sales figure separately with a corresponding reduction in the value of the biological assets)			
Bank	Dr.	19,450	
Selling expenses (150 + 400)	Dr.	550	
To Revenue			20,000
(Recognition of revenue from sale of goat)			

Transfer of Goat to Inventory on 15 September 20X2 (All figures are in ₹)

Inventory (48,300 - 420)	Dr.	47,880	
Loss on remeasurement	Dr.	1,176	
To Biological Asset (Goat)			44,856#
To Bank (Slaughtering cost)			4,200
(Transfer of goat to inventory)			

#Note: 44,856 is calculated as the proportion of goat sold using the fair value $(1,06,800 + 226 - 19,450) \times 42/82$

Subsequent measurement of goat at 30 September 20X2 (All figures are in ₹)

Biological Asset (Goat)	Dr.	784	
To Gain on remeasurement			784
(Subsequent measurement of Goat at fair value less costs to sell [43,504## – {(1,06,800 + 226 – 19,450) – 44,856}])			

##Fair value of goat = 44,800 – 400 – 896 (2% of 44,800) = 43,504

Illustration 8 (Past Exam Jan'21)

On 1st November, 20X1, C Agro Ltd. purchased 100 goats of special breed from a market for ₹ 10,00,000 with a transaction cost of 2%. Goats fair value decreased from ₹ 10,00,000 to ₹ 9,00,000 as on 31st March, 20X2.

Determine the fair value on the date of purchase and as on financial year ended 31st March, 20X2 under both the cases viz-

- The transaction costs are borne by the seller and
- The transaction costs are incurred by the seller and purchaser both.

Also pass journal entries under both the situations on both dates.

(4 Marks)

Solution

As per para 12 of Ind AS 41, a biological asset shall be measured on initial recognition and at the end of each reporting period at its fair value less costs to sell. Therefore, regardless of who bears the transaction costs, the transaction costs of 2% are the costs to sell the goats on 1st November 20X1, and therefore, the goats should be measured at their fair value less costs to sell on initial recognition date, i.e., ₹ 9,80,000.

Journal Entry

As on 1st November 20X1:

(i) Where transaction costs are borne by the seller:

Biological assets (Goats) A/c	Dr. 9,80,000	
Loss on purchase of biological assets (Goats) A/c	Dr. 20,000	
To Bank A/c		10,00,000

(ii) Where transaction costs are borne by the buyer:

Biological assets (Goats) A/c	Dr. 9,80,000	
Loss on purchase of biological asset (Goats) A/c	Dr. 40,000	
To Bank A/c		10,20,000

As on 31 March 20X2 – under both the scenarios:

Loss on fair valuation of biological assets A/c	Dr. 98,000	
To Biological assets (Goats) A/c		98,000
[9,80,000 - (9,00,000 - 18,000)]		

Illustration 9 - (RTP May'21), (MTP Nov'22, Nov'23)

Analyse whether the following activities fall within the scope of Ind AS 41 with proper reasoning:

- ✓ Managing animal-related recreational activities like Zoo
- ✓ Fishing in the ocean
- ✓ Fish farming
- ✓ Development of living organisms such as cells, bacteria and viruses
- ✓ Growing of plants to be used in the production of drugs
- ✓ Purchase of 25 dogs for security purpose of the company's premises.

(6 Marks)

Solution

Activity	Whether in the scope of Ind AS 41?	Remarks
Managing animal-related recreational activities like Zoo	No	Since the primary purpose is to show the animals to public for recreational purposes, there is no management of biological transformation but simply control of the number of animals. Hence it will not fall in the purview of considered in the definition of agricultural activity.
Fishing in the ocean	No	Fishing in ocean is harvesting biological assets from unmanaged sources. There is no management of biological transformation since fish grow naturally in the ocean. Hence, it will not fall in the scope of the definition of agricultural activity.

Fish farming	Yes	Managing the growth of fish and then harvest for sale is agricultural activity within the scope of Ind AS 41 since there is management of biological transformation of biological assets for sale or additional biological assets.
Development of living organisms such as cells, bacteria viruses	Analysis required	The development of living organisms for research purposes does not qualify as agricultural activity, as those organisms are not being developed for sale, or for conversion into agricultural produce or into additional biological assets. Hence, development of such organisms for the said purposes does not fall under the scope of Ind AS 41.
		However, if the organisms are being developed for sale or use in dairy products, the activity will be considered as agricultural activity under the scope of Ind AS 41.
Growing of plants to be used in the production of drugs	Yes	If an entity grows plants for using it in production of drugs, the activity will be agricultural activity. Hence it will come under the scope of Ind AS 41.
Purchase of 25 dogs for security purposes of the company's premises	No	Ind AS 41 is applied to account for the biological assets when they relate to agricultural activity. Guard dogs for security purposes do not qualify as agricultural activity, since they are not being kept for sale, or for conversion into agricultural produce or into additional biological assets. Hence, they are outside the scope of Ind AS 41.

Illustration 10

Agro Foods Ltd. runs a poultry farm business. It has received a government grant from the government for setting up a new poultry unit in a backward area. Agro Foods Ltd used the amount of government grants to buy the first batch of broiler birds, incubators etc. The broiler birds are measured at fair value less costs to sell. However, the incubator machine is measured as per the cost model in Ind AS 16.

As such there are no conditions attached to the release of the government grants pertaining to purchase of poultry birds. However, as regards the investment in incubators and other related plant and machinery items, the government grant contains a condition that the plant and machinery item should be used for a minimum period of 3 years. The useful life of the incubator machine has also been determined to be 3 years in accordance with the management estimate of the time period over which the economic benefits embedded in the incubator machine shall be consumed.

Advise the accounting requirements prescribed in Ind AS 41 Agriculture and Ind AS 20 Accounting for Government Grants and Disclosure of Government Assistance in respect of both the government grants?

Solution:

Ind AS 41 requires an unconditional government grant related to a biological asset measured at its fair value less costs to sell to be recognised in profit or loss when, and only when, the government grant becomes receivable. Accordingly, the amount of government grant attributable to the broiler birds which qualify as a biological bird shall be recognized in profit or loss account when the grant becomes receivable.

If a government grant is conditional, including when a government grant requires an entity not to engage in specified agricultural activity, an entity should recognize the government grant in profit or loss when, and only when, the conditions attaching to the government grant are met. This provision of Ind AS 41 is not applicable as we have been informed that there are no conditions attached to the release of the government grant pertaining to broiler birds. In the given case, the grant related to broiler birds has already been received for the purpose of providing immediate financial support to the entity with no future related conditions to be fulfilled. Accordingly, the grant relating to broiler birds is to be recognized in profit and loss in the period in which it is received.

If a government grant relates to a biological asset measured at its cost less any accumulated depreciation and any accumulated impairment losses, the entity applies Ind AS 20 Accounting for Government Grants

and Disclosure of Government Assistance. The incubator machine does not qualify as a biological asset as it is specifically covered by Ind AS 16 which states that plant and machinery items used to develop or maintain biological assets is covered by Ind AS 16. Therefore, the provisions relating to Government grants contained in Ind AS 41 will not apply to the incubator machine. Therefore, we have to apply directly the provisions contained in IAS 20. Ind AS 20 contains two methods of presentation in financial statements of grants (or the appropriate portions of grants) related to assets are regarded as acceptable alternatives:

- One method recognises the grant as deferred income that is recognized in profit or loss on a systematic basis over the useful life of the asset.
- The other method deducts the grant in calculating the carrying amount of the asset. The grant is recognized in profit or loss over the life of a depreciable asset as a reduced depreciation expense.

Therefore, the grant relating to incubator machine will have to be accounted as a deferred income that is recognized in Profit or loss on a systematic basis over a period of 3 years in line with the condition attached to the grant. Alternatively, the grant may be deducted in determining the carrying amount of the incubator. In such a case the grant is recognised in Profit or Loss over the 3-year useful life of the depreciable incubator machine as a reduced depreciation expense.

MOCK TEST PAPER / REVISION TEST PAPER / PAST EXAM

Question 1 (PAST EXAM Nov'19)

Arun Ltd. is an entity engaged in plantation and farming on a large scale and diversified across India. On 1st April, 2018, the company has received a government grant for

₹ 20 lakh 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 trees for specified period of five years and accordingly it recognizes proportionate grant for ₹ 4 lakh 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.

Required:

Evaluate whether the above accounting treatment made by the management is in compliance with the applicable Ind AS. If not, advise the correct treatment. (4 Marks)

Solution

Arun Ltd. is engaged in plantation and farming on a large scale. This implies that it has agriculture business. Hence, Ind AS 41 will be applicable.

Further, the government grant has been given subject to a condition that it will continue to engage in plantation of eucalyptus tree for a coming period of five years. This implies that it is a conditional grant.

In the absence of the measurement base of biological asset, it is assumed that "Arun Ltd measures its Biological Asset at fair value less cost to sell":

(i) As per Ind AS 41, the government grant should be recognised in profit or loss when, and only when, the conditions attaching to the government grant are met i.e. continuous plantation of eucalyptus tree for coming period of 5 years. In this case, the grant shall not be recognised in profit or loss until the five years have passed. The entity has recognised the grant in profit and loss on proportionate basis, which is incorrect.

(ii) 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. Accordingly, the entity can recognise the proportionate grant for ₹ 4 lakh in the statement of Profit and Loss based on the terms of the grant.

Alternatively, it may be assumed that Arun Ltd. measures its Biological Asset at its cost less any accumulated depreciation and any accumulated impairment losses (as per para 30 of Ind AS 41):

In such a situation, principles of Ind AS 20 (with respect to conditional grant will apply). According to Ind AS 20, the conditional grant should be recognised in the Statement of Profit and Loss over the periods and in the proportions in which depreciation expense on those assets is recognised. Hence the proportionate recognition of grant ₹ 4 lakh (20 lakh / 5) as income is correct since the entity has reasonable assurance that the entity will comply with the conditions attached to the grant.

Note: In case eucalyptus tree is considered as bearer plant by Arun Ltd., then Ind AS 20 will be applicable and not Ind AS 41.

Question 2 (RTP Nov'22)

ABC Ltd. is in the business of manufacturing an apple beverage and requires large quantity of apples to manufacture such beverage. In order to satisfy its requirement of apples, it enters into 3 years lease contracts with owners of apple orchards. The lease contracts are mainly of two types:

- (1) **Contract 1:** The owner of the apple orchard (i.e. the lessor) raises the apple trees to produce apples. ABC Ltd. (i.e. lessee) makes a fixed annual payment to the owner of the apple orchard who is required to cultivate the produce as per the specifications of ABC Ltd. ABC Ltd. harvests the apples itself for fulfilling its requirement of apples.
- (2) **Contract 2:** ABC Ltd. obtains the apple orchard from owner (i.e. the lessor) to raise the apple trees for subsequent harvest of the apples to ensure that the apples are as per the requirements of ABC Ltd. ABC Ltd. makes a fixed annual payment to the owner of the apple orchards (i.e. the lessor).

Explain whether ABC Ltd. is engaged in agricultural activity as per Ind AS 41 in both of the cases?

Solution:

Paragraph 5 of Ind AS 41, Agriculture defines agricultural activity and biological transformation as follows:

"Agricultural activity is 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."

"Biological transformation comprises the processes of growth, degeneration, production, and procreation that cause qualitative or quantitative changes in a biological asset."

Contract 1:

As per contract 1, during the 3 years of the contract, ABC Ltd. only harvests apples from the apple orchards whereas biological transformation is managed by the owners of the apple orchards (i.e. the lessor). Since ABC Ltd. is not involved in the biological transformation of the apple orchards and is only harvesting biological assets, it cannot be said to be an agricultural activity as per Ind AS 41. Hence, ABC Ltd. is not engaged in agricultural activity as per Ind AS 41.

Contract 2:

As per contract 2, ABC Ltd. obtains the apple orchards and is actively involved in the raising of apple trees in order to ensure that the apples are as per its requirements. Since, it is actively managing the biological transformation and harvest of biological asset, Hence, ABC Ltd. is engaged in agricultural activity as per Ind AS 41.

Question 3 (Past Exam Nov'22)

A herd of 15, 4 year old cows valued at ₹ 500 thousands per cow were held in 'M Dairy Farm' as at 1st April 2021. The following transactions took place on 1st October, 2021:

- One cow aged 4.5 years was purchased for ₹ 520 thousands.
- One calf was born.

No cow was sold or disposed off during the year.

The per cow/calf fair value less cost to sell was as follows: ₹ in thousands

4 year old cow on 1st April 2021	500
New born calf on 1st October 2021	400
4.5 year old cow on 1st October 2021	520
New born calf on 31st March, 2022	410
0.5 year old calf on 31st March, 2022	440
4 year old cow on 31st March, 2022	516
4.5 year old cow on 31st March, 2022	540
5 year old cow on 31st March, 2022	560

You are required to:

- Calculate change in fair value less costs to sell showing:
 - The portion attributable to physical changes
 - The portion attributable to price changes
- Calculate the carrying cost of the herd as on 31st March, 2022.
- Prepare an extract of the livestock account for the year ended 31st March, 2022.

(6 Marks)

Solution

- (a) Change in fair value less costs to sell, due to physical change and price change:

₹ in thousand

Fair value less costs to sell of herd at 1st April 2021 (15 × 500)		7,500
Purchase on 1st October 2021 (1 × 520)		520
(a)	Increase in fair value less costs to sell due to price change:	
	15 cows x (516 – 500)	240
	1 cows x (540 – 520)	20
	1 calf x (410 – 400)	10
		270

(b)	Increase in fair value less costs to sell due to physical change:	
	15 cows x (560 – 516)	660
	1 cows x (560 – 540)	20
	1 calf x (440 – 410)	30
	1 calf x 400 (Gain on initial recognition)	400
		1,110
		9,400

(ii) Calculation of carrying cost of herd as on 31st March 2022 i.e.

Fair value less costs to sell of herd at 31st March 2022

16 × 560	8,960
1 × 440	440
	9,400

(iii) Extract of Livestock Account for the year 31st March 2022

Particulars	Amount (₹ in 000)	Particulars	Amount (₹ in 000)
To Opening Stock	7500	By Closing Balance	9,400
To Purchases (1x520)	520		
To Increase in fair value (Price Changes)	270		
To Increase in fair value (Physical Changes)	1,110		
Total	9,400	Total	9,400

Question 4 (RTP May 23)

Fisheries Ltd. practices pisciculture in sweet waters (ponds, tanks and dams). The fishing activity of Fisheries Ltd. in such sweet waters consists only of catching the fishes. Comment whether such fishing activity will be covered within the scope of Ind AS 41?

Solution:

Paragraph 5 of Ind AS 41, defines agricultural activity as follows: "Agricultural activity is 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."

For fishing to qualify as agricultural activity, it must satisfy both of the below mentioned conditions:

- a) management of biological transformation of a biological asset; and
- b) harvesting of biological assets for sale or for conversion into agricultural produce or into additional biological assets.

Therefore, when fishing involves managed activity to grow and procreate fishes in designated areas, such fishing is an agricultural activity as per the above definition.

Managing the growth of fish for subsequent sale is an agricultural activity as per Ind AS 41.

In the aforementioned scenario, only fish harvesting is managed by Fisheries Ltd.

Therefore, mere fish harvesting without management of biological transformation cannot be termed as an agricultural activity as per Ind AS 41.

Hence, fishing in sweet waters (pond, tanks and dams) where only fishing (harvesting) is carried out without any management of biological transformation is outside the scope of Ind AS 41.

Question 5 (RTP Nov'23)

M. Chinnaswamy & Brothers Ltd. is a company that is engaged in growing and maintaining coconut palms and selling their output in various forms. The company has a farmland having 2,00,000 coconut palms in the coastal area of Karnataka near Mangalore.

The fair value of each coconut palm is derived based on the average realisable price of ₹ 30 per nut (fruit). Each coconut palm grows 80 nuts per annum on an average basis. Each coconut palm can generate revenue for as long as 80 years and the current palms are only 20-year-old. The management thinks that considering the risk factors in business, the valuation of each palm can be considered at 5 times its annual revenue.

During August, 20X5, the Ooty Hotels Association (OHA) chairman and his team visited the corporate office of the company at Mangalore. The deal was to supply tender coconuts to Ooty Hotels at an agreed price throughout the year. The agreement came into effect from 1st September, 20X5 whereby the company shall reserve 15,000 coconut palms (out of 2,00,000 coconut palms) for OHA and will charge a concessional rate of ₹ 15 only per nut supplied to OHA. OHA will in turn supply the tender coconuts to each Ooty Hotel at the same price. This contract price is applicable irrespective of the ownership of palm trees (it is not an entity-specific restriction). All tender coconuts of these 15,000 coconut palms were used by OHA irrespective of the agreement being effective from 1st September, 20X5.

What will be the valuation of 2,00,000 coconut palms in the company's farm for the quarter ended 30th September, 20X5?

Solution:

Para 16 of Ind AS 41 says that entities often enter into contracts 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 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.

Moreover, the OHA contract represents just 7.5% $[(15,000 / 2,00,000) \times 100]$ of the total number of palms in the farm. Hence, the contract price can't be considered for fair valuation of the entire inventory of bearer plants.

The valuation in this case would be as follows:

Adding the fair value for 15,000 coconut palm (15,000 palm $\times$ 80 nuts $\times$ ₹ 15 $\times$ 5 times) and 1,85,000 coconut palm (1,85,000 palm $\times$ 80 nuts $\times$ ₹ 30 $\times$ 5 times), we get total valuation of 2,00,000 coconut palm as ₹ 231 crore.

IND AS 101: FIRST TIME ADOPTION OF IND AS

Illustration 1

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 (i.e. year 20X1-20X2), 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.

Illustration 2

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.

Illustration 3

E Ltd. is required to first time adopt Indian Accounting Standards (Ind AS) from 1 April 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, 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.

Illustration 4

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.

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.

Illustration 5

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.

Illustration 6

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 (for example, if the parent is a non-banking financial company and the subsidiary is a trading or manufacturing company) then it does not change the amounts already recognised by the subsidiary.

Illustration 7 (MTP May'24)

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.

Illustration 8

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.

Illustration 9

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.

Illustration 10

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.

Illustration 11

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.

Illustration 12

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 = ₹ 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 which requires all foreign exchange differences to be recognised in profit or loss, except such foreign exchange differences which are accounted for as an adjustment to borrowing costs in accordance with Ind AS 23.

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.

Illustration 13

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.

Illustration 14

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.

Illustration 15 – (RTP May'20) (Past Exam Nov'18) (MTP March'22)

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

(6 Marks)

Solution

The carrying amount of the debenture on the date of transition under previous GAAP, assuming that all interest accrued other than premium on redemption have been paid, will be ₹ 31,50,000 [(30,000 x 100) +

(30,000 x 100 x 10/100 x 2/4)]. The premium payable on redemption is being recognised as borrowing costs as per para 4(b) of AS 16 ie under previous GAAP on straight-line basis.

As per para D18 of Ind AS 101, 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 per debenture	93.82
Equity component per debenture (Balancing figure)	6.18
Face value of debentures	100.00
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

However, on the date of transition, unwinding of ₹ 28,14,600 will be done for two years as follows:

Year	Opening balance	Finance cost @ 10%	Interest paid	Closing balance
1	28,14,600	2,81,460	1,80,000	29,16,060
2	29,16,060	2,91,606	1,80,000	30,27,666

Therefore, on transition date, Sigma Ltd. shall –

- recognise the carrying amount of convertible debentures at ₹ 30,27,666;
- recognise equity component of compound financial instrument of ₹ 1,85,400;
- debit ₹ 63,066 to retained earnings being the difference between the previous GAAP amount of ₹ 31,50,000 and ₹ 30,27,666 and the equity component of compound financial instrument of ₹ 1,85,400; and
- derecognise the debenture liability in previous GAAP of ₹ 31,50,000.

Notes:

- 3.17 is present value of annuity factor of ₹ 1 at a discount rate of 10% for 4 years.
- On maturity, ₹ 110 will be paid (₹ 100 as principal payment + ₹ 10 as premium)

Illustration 16 - MTP (Oct 2019)

H Ltd. has the following assets and liabilities as at March 31, 20x1, prepared in accordance with previous GAAP:

Particulars	Notes	Amount (₹)
Property, Plant and Equipment	1	1,34,50,000
Investments in S. Ltd.	2	48,00,000
Debtors		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:

- In relation to property, plant and equipment, the following adjustments were identified:
 - Property, plant and equipment 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 fixed assets 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.
- 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.
- Financial instruments:
 - VAT Deferral loan ₹60,00,000 :**
 The 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.

Prepare transition date Ind AS balance sheet of Company H showing adjustments to the values of assets and liabilities

Solution

Adjustments for opening balance sheet as per Ind AS 101

- PPE:** 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.
- 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.
- 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.
- 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.
- Cumulative translation difference :** As per paragraph D 12 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.
- 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 earnings to retained (note 5)	1,00,000
Increase in Retained Earnings	20,99,000

The transition date Ind AS Balance Sheet after the above adjustments in the carrying values of assets and liabilities is as under:

Transition date Ind AS Balance Sheet of H Ltd. as at 1st April, 20X1

Particular	Notes	Previous GAAP	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
Current Assets				
Inventory		8,00,000		8,00,000
Financial assets:				
Investment in S Ltd.	2	48,00,000	20,00,000	68,00,000
Trade Receivables		2,00,000		2,00,000
Cash		49,000		49,000
Other current asset – (Advances for purchase of inventory)		50,00,000		50,00,000
Total assets		2,42,99,000	20,00,000	2,62,99,000
Share capital		1,30,00,000		1,30,00,000
Other Equity:				
Cumulative translation difference	5	1,00,000	(1,00,000)	0
ESOP reserve	4	20,000	1,000	21,000
Retained earnings	6	1,79,000	20,99,000	22,78,000
Total equity		1,32,99,000	20,00,000	1,52,99,000
Non-current Liabilities				
Financial liability:				
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				
Financial Liabilities				
Trade payables		30,00,000		30,00,000
Short term borrowings		8,00,000		8,00,000
Provisions		12,00,000		12,00,000
Total liabilities		1,10,00,000		1,10,00,000
Total equity and liabilities		2,42,99,000	20,00,000	2,62,99,000

Illustration 17 - (MTP Oct'20)

Shaurya Limited is the company having its registered and corporate office at New Delhi. 60% of the Shaurya Limited's shares are held by the Government of India and rest by other investors.

This is the first time that Shaurya limited would be applying Ind AS for the preparation of its financials for the current financial year 2019-2020. Following balance sheet is prepared as per earlier GAAP as at the beginning of the preceding period along with the additional information:

Balance Sheet as at 31 March 2018

(All figures are in '000, unless otherwise specified)

Particulars	Amount
EQUITY AND LIABILITIES	
(1) Shareholders' Funds	
(a) Share Capital	10,00,000
(b) Reserves & Surplus	25,00,000
(2) Non-Current Liabilities	
(a) Long Term Borrowings	4,50,000
(b) Long Term Provisions	3,50,000
(c) Deferred tax liabilities	3,50,000
(3) Current Liabilities	
(a) Trade Payables	22,00,000
(b) Other Current Liabilities	4,50,000
(c) Short Term Provisions	12,00,000
TOTAL	85,00,000
ASSETS	
(1) Non-Current Assets	
(a) Property, Plant & Equipment (net)	20,00,000
(b) Intangible assets	2,00,000
(c) Goodwill	1,00,000
(d) Non-current Investments	5,00,000
(e) Long Term Loans and Advances	1,50,000
(f) Other Non-Current Assets	2,00,000
(2) Current Assets	
(a) Current Investments	18,00,000
(b) Inventories	12,50,000
(c) Trade Receivables	9,00,000
(d) Cash and Bank Balances	10,00,000
(e) Other Current Assets	4,00,000
TOTAL	85,00,000

Additional Information (All figures are in '000) :

- Other current liabilities include ₹ 3,90,000 liabilities to be paid in cash such as expense payable, salary payable etc. and ₹ 60,000 are statutory government dues.
- Long term loans and advances include ₹ 40,000 loan and the remaining amount consists Advance to staff of ₹ 1,10,000.
- Other non-current assets of ₹ 2,00,000 consists Capital advances to suppliers.
- Other current assets include ₹ 3,50,000 current assets receivable in cash and Prepaid expenses of ₹ 50,000.
- Short term provisions include Dividend payable of ₹ 2,00,000. The dividend payable had been as a result of board meeting wherein the declaration of dividend for financial year 2017 -2018 was made. However, it is subject to approval of shareholders in the annual general meeting.

Chief financial officer of Shaurya Limited has also presented the following information against corresponding relevant items in the balance sheet:

- Property, Plant & Equipment consists a class of assets as office buildings whose carrying amount is ₹ 10,00,000. However, the fair value of said office building as on the date of transition is estimated to be ₹ 15,00,000. Company 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.
- The fair value of Intangible assets as on the date of transition is estimated to be ₹ 2,50,000. However, the management is reluctant to incorporate the fair value changes in books of account.
- Shaurya Ltd. had acquired 80% shares in a company, Excel private limited few years ago thereby acquiring the control upon it at that time. Shaurya Ltd. recognised goodwill as per erstwhile accounting standards by accounting the excess of consideration paid over the net assets acquired at the date of acquisition. Fair value exercise was not done at the time of acquisition.
- Trade receivables include an amount of ₹ 20,000 as provision for doubtful debts measured in accordance with previous GAAP. Now as per latest estimates, the provision needs to be revised to ₹ 25,000.
- Company had given a loan of ₹1,00,000 to an entity for the term of 10 years six years ago. Transaction costs were incurred separately for this loan. The loan carries an interest rate of 7%. The principal amount is to be repaid in equal installments over the period of ten years at the year end. Interest is also payable at each year end. The fair value of loan as on the date of transition is ₹ 50,000 as against the carrying amount of loan which at present amounts to ₹ 40,000. However, Ind AS 109 mandates to charge the interest expense as per effective interest method after the adjustment of transaction costs. Management says it is tedious task in the given case to apply the effective interest rate changes with retrospective effect and hence is reluctant to apply the same retrospectively in its first time adoption.
- In the long term borrowings, ₹ 4,50,000 of component is due towards the State Government. Interest is payable on the government loan at 4%, however the prevailing rate in the market at present is 8%. The fair market value of loan stands at ₹ 4,20,000 as on the relevant date.
- Under Previous GAAP, the mutual funds were measured at cost or market value, whichever is lower. Under Ind AS, the Company has designated these investments at fair value through profit or loss. The value of mutual funds as per previous GAAP is ₹ 2,00,000 as included in 'current investment'. However, the fair value of mutual funds as on the date of transition is ₹ 2,30,000.
- Ignore separate calculation of deferred tax on above adjustments. Assume the net deferred tax income to be ₹ 50,000 on account of Ind AS transition adjustments.

Requirements:

- Prepare transition date balance sheet of Shaurya Limited as per Indian Accounting Standards
- Show necessary explanation for each of the items presented by chief financial officer in the form of notes, which may or may not require the adjustment as on the date of transition.

(20 Marks)

Solution**Transition date (opening) IND-AS BALANCE SHEET of SHAURYA LIMITED****As at 1 April 2018***(All figures are in '000, unless otherwise specified)*

Particulars	Previous GAAP	Transitional Ind AS adjustments	Opening Ind AS Balance sheet
ASSETS			
Non-current assets			
Property, plant and equipment (Note 1)	20,00,000	5,00,000	25,00,000
Goodwill (Note 2)	1,00,000	-	1,00,000

Other Intangible assets (Note 3)	2,00,000	-	2,00,000
Financial assets:			
Investment	5,00,000	-	5,00,000
Loans (Note 4)	40,000	10,000	50,000
Other financial assets	1,10,000	-	1,10,000
Other non-current assets	2,00,000	-	2,00,000
Current assets			
Inventories	12,50,000	-	12,50,000
Financial assets			
Investment (Note 5)	18,00,000	30,000	18,30,000
Trade receivables (Note 6)	9,00,000	-	9,00,000
Cash and cash equivalents/Bank	10,00,000	-	10,00,000
Other financial assets	3,50,000	-	3,50,000
Other current assets	50,000	-	50,000
TOTAL ASSETS	85,00,000	5,40,000	90,40,000
EQUITY AND LIABILITIES			
Equity			
Equity share capital	10,00,000	-	10,00,000
Other equity	25,00,000	7,90,000	32,90,000
Non-current liabilities			
Financial liabilities			
Borrowings (Note-7)	4,50,000	-	4,50,000
Provisions	3,50,000	-	3,50,000
Deferred tax liabilities (Net)	3,50,000	(50,000)	3,00,000
Current liabilities			
Financial liabilities			
Trade payables	22,00,000	-	22,00,000
Other financial liabilities	3,90,000	-	3,90,000
Other current liabilities	60,000	-	60,000
Provisions (Note-8)	12,00,000	(2,00,000)	10,00,000
TOTAL EQUITY AND LIABILITIES	85,00,000	5,40,000	90,40,000

OTHER EQUITY

	Retained Earnings (₹)	Fair value reserve	Total
As at 31 March, 2018	27,90,000 (W.N.1)	5,00,000	32,90,000

Working Note 1:**Retained earnings balance:**

Balance as per Earlier GAAP	25,00,000
Transitional adjustment due to loan's fair value	10,000
Transitional adjustment due to increase in mutual fund's fair value	30,000

Transitional adjustment due to decrease in deferred tax liability	50,000
Transitional adjustment due to decrease in provisions (dividend)	2,00,000
Total	27,90,000

Disclosure forming part of financial statements:

Proposed dividend on equity shares is subject to the approval of the shareholders of the company at the annual general meeting and should not be recognized as liability as at the Balance Sheet date.

Note 1: Property, plant & Equipment:

As per para D5 of Ind AS 101, an entity may elect to measure an item of property, plant and equipment at the date of transition to Ind AS at its fair value and use that fair value as its deemed cost at that date.

Note 2: Goodwill:

Ind AS 103 mandatorily requires measuring the assets and liabilities of the acquiree at its fair value as on the date of acquisition. However, a first time adopter may elect to not apply the provisions of Ind AS 103 with retrospective effect that occurred prior to the date of transition to Ind AS.

Hence company can continue to carry the goodwill in its books of account as per the previous GAAP.

Note 3: Intangible assets:

Para D7 read with D6 of Ind AS 101 states that a first-time adopter may elect to use a previous GAAP revaluation 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.

However, there is a requirement that Intangible assets must meet the definition and recognition criteria as per Ind AS 38.

Hence, company can avail the exemption given in Ind AS 101 as on the date of transition to use the carrying value as per previous GAAP.

Note 4: Loan

Para B8C of Ind AS 101 states that 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 ASs 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.

Accordingly, ₹ 50,000 would be the gross carrying amount of loan and difference of ₹ 10,000 (₹ 50,000 – ₹ 40,000) would be adjusted to retained earnings.

Note 5: Mutual Funds

Para 29 of Ind AS 101 states that an entity is permitted to designate a previously recognised financial asset as a financial asset measured at fair value through profit or loss in accordance with paragraph D19A. The entity shall disclose the fair value of financial assets so designated at the date of designation and their classification and carrying amount in the previous financial statements.

D19A states that an entity may designate a financial asset as measured at fair value through profit or loss in accordance with Ind AS 109 on the basis of the facts and circumstances that exist at the date of transition to Ind AS.

Note 6: Trade receivables

Para 14 of Ind AS 101 states that an entity's estimates in accordance with Ind ASs 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.

Para 15 of Ind AS 101 further states that an entity may receive information after the date of transition to Ind ASs about estimates that it had made under previous GAAP. In accordance with paragraph 14, an entity shall treat the receipt of that information in the same way as non-adjusting events after the reporting period in accordance with Ind AS 10, Events after the Reporting Period.

The entity shall not reflect that new information in its opening Ind AS Balance Sheet (unless the estimates need adjustment for any differences in accounting policies or there is objective evidence that the estimates were in error). Instead, the entity shall reflect that new information in profit or loss (or, if appropriate, other comprehensive income) for the year ended 31 March 2019.

Note 7: Government Grant

Para 10A of Ind AS 20 states that the benefit of a government loan at a below-market rate of interest is treated as a government grant. The loan shall be recognised and measured in accordance with Ind AS 109, Financial Instruments. The benefit of the below-market rate of interest shall 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 this Standard.

However, Para B10 of Ind AS 101 states, 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. Except as permitted by paragraph B11, 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 ASs and shall not recognise the corresponding benefit of the government loan at a below-market rate of interest as a government grant. Consequently, if a first-time adopter did not, under its previous GAAP, recognise and measure a government loan at a below-market rate of interest on a basis consistent with Ind AS requirements, it shall use its previous GAAP carrying amount of the loan at the date of transition to Ind AS as the carrying amount of the loan in the opening Ind AS Balance Sheet. An entity shall apply Ind AS 109 to the measurement of such loans after the date of transition to Ind AS.

Note 8: Dividend

Dividend should be deducted from retained earnings during the year when it has been declared and approved. Accordingly, the provision declared for preceding year should be reversed (to rectify the wrong entry). Retained earnings would increase proportionately due to such adjustment.

Illustration 18

Company A intends to restate its past business combinations with effect from 30 June 20 X0 (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?

Solution

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 20 X0 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.

Illustration 19

X Ltd. was using cost model for its property, plant and equipment till March 31, 20 X2 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?

Solution

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.

Illustration 20

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, The Effects of Changes in Foreign Exchange Rates with respect to recognition of foreign 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. 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.

Illustration 21

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?

Solution

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.

Illustration 22 - (RTP - May 2019)

XYZ Pvt. Ltd. is a company registered under the Companies Act, 2013 following Accounting Standards notified under Companies (Accounting Standards) Rules, 2006. The Company has decided to voluntarily adopt Ind AS w.e.f 1st April, 20X2 with a transition date of 1st April, 20X1.

The Company has one Wholly Owned Subsidiary and one Joint Venture which are into manufacturing of automobile spare parts.

The consolidated financial statements of the Company under Indian GAAP are as under

Consolidated Financial Statements

Particulars	31.03.20X2	31.03.20X1
Shareholder's Funds		
Share Capital	7,953	7,953
Reserves & Surplus	16,547	16,597
Non-Current Liabilities		
Long Term Borrowings	1,000	1,000
Long Term Provisions	1,101	691
Other Long-Term Liabilities	5,202	5,904
Current Liabilities		
Trade Payables	9,905	8,455
Short Term Provisions	500	475
Total	42,208	41,075
Non-Current Assets		
Property Plant & Equipment	21,488	22,288
Goodwill on Consolidation of subsidiary and JV	1,507	1,507
Investment Property	5,245	5,245
Long Term Loans & Advances	6,350	6,350
Current Assets		
Trade Receivables	4,801	1,818
Investments	1,263	3,763
Other Current Assets	1,554	104
Total	42,208	41,075

Additional Information:

The Company has entered into a joint arrangement by acquiring 50% of the equity shares of ABC Pvt. Ltd. Presently, the same has been accounted as per the proportionate consolidated method. The proportionate share of assets and liabilities of ABC Pvt. Ltd. included in the consolidated financial statement of XYZ Pvt. Ltd. is as under:

Particulars	₹ in Lakhs
Property, Plant & Equipment	1,200

Long Term Loans & Advances	405
Trade Receivables	280
Other Current Assets	50
Trade Payables	75
Short Term Provisions	35

The Investment is in the nature of Joint Venture as per Ind AS 111.

The Company has approached you to advice and suggest the accounting adjustments which are required to be made in the opening Balance Sheet as on 1st April, 20X1.

Solution

As per paras D31AA and D31AB of Ind AS 101, when changing from proportionate consolidation to the equity method, an entity shall recognise its investment in the joint venture at transition date to Ind AS.

That initial investment shall be measured as the aggregate of the carrying amounts of the assets and liabilities that the entity had previously proportionately consolidated, including any goodwill arising from acquisition. If the goodwill previously belonged to a larger cash-generating unit, or to a group of cash-generating units, the entity shall allocate goodwill to the joint venture on the basis of the relative carrying amounts of the joint venture and the cash-generating unit or group of cash-generating units to which it belonged. The balance of the investment in joint venture at the date of transition to Ind AS, determined in accordance with paragraph D31AA above is regarded as the deemed cost of the investment at initial recognition.

Accordingly, the deemed cost of the Investment will be

Property, Plant & Equipment	1,200
Goodwill (Refer Note below)	119
Long Term Loans & Advances	405
Trade Receivables	280
Other Current Assets	50
Total Assets	2,054
Less: Trade Payables	75
Short Term Provisions	35
Deemed cost of the investment in JV	1,944

Calculation of proportionate goodwill share of Joint Venture ie ABC Pvt. Ltd.

Property, Plant & Equipment	22,288
Goodwill	1,507
Long Term Loans & Advances	6,350
Trade Receivables	1,818
Other Current Assets	104
Total Assets	32,067
Less: Trade Payables	8,455
Short Term Provisions	475
	23,137

Note: Only those assets and liabilities have been taken into account for calculation of „proportionate goodwill share of Joint Venture“, which were given in the question as proportionate share of assts and liabilities of ABC Ltd. added to XYZ Ltd.” Proportionate Goodwill of Joint Venture

= [(Goodwill on consolidation of subsidiary and JV/Total relative net asset) x Net asset of JV]

$$= (1507 / 23,137) \times 1825 = 119 \text{ (approx.)}$$

Accordingly, the proportional share of assets and liabilities of Joint Venture will be removed from the respective values assets and liabilities appearing in the balance sheet on 31.3.20X1 and Investment in JV will appear under non-current asset in the transition date balance sheet as on 1.4.20X1.

Adjustments made in previous GAAP balance sheet to arrive at Transition date Ind AS Balance Sheet

Transition Date Ind AS Balance Sheet of XYZ Pvt. Ltd. as at 1st April, 20X1

Particulars	Previous GAAP	Ind AS Adjustment	Ind AS GAAP
Non-Current Assets			
Property, Plant & Equipment	22,288	(1,200)	21,088
Investment Property	5,245	-	5,245
Intangible assets - Goodwill on Consolidation	1,507	(119)	1,388
Financial Assets			
Long Term Loans & Advances	6,350	(405)	5,945
Non- current investment in JV	-	1,944	1,944
Current Assets			
Financial Assets			
Investments	3,763	-	3,763
Trade Receivables	1,818	(280)	1,538
Other Current Assets	104	(50)	54
Total	41,075	(110)	40,965
Equity and liabilities			
Equity			
Share Capital	7,953	-	7,953
Other equity	16,597	-	16,597
Non-Current Liabilities			
Financial Liabilities			
Borrowings	1,000		1,000
Long Term Provisions	691		691
Other Long-Term Liabilities	5,904		5,904
Current Liabilities			
Financial Liabilities			
Trade Payables	8,455	(75)	8,380
Short Term Provisions	475	(35)	440
Total	41,075	(110)	40,965

Illustration 23 (MTP Nov'23)

Mathur India Private Limited has to present its first financials under Ind AS for the year ended 31st March, 20X3. The transition date is 1st April, 20X1.

The following adjustments were made upon transition to Ind AS:

- The Company opted to fair value its land as on the date on transition.
The fair value of the land as on 1st April, 20X1 was ₹ 10 crores. The carrying amount as on 1st April, 20X1 under the existing GAAP was ₹ 4.5 crores.
- The Company has recognised a provision for proposed dividend of ₹ 60 lacs and related dividend distribution tax of ₹ 18 lacs during the year ended 31st March, 20X1. It was written back as on opening balance sheet date.
- The Company fair values its investments in equity shares on the date of transition. The increase on account of fair valuation of shares is ₹ 75 lacs.

- d) The Company has an Equity Share Capital of ₹ 80 crores and Redeemable Preference Share Capital of ₹ 25 crores.
- e) The reserves and surplus as on 1st April, 20X1 before transition to Ind AS was ₹ 95 crores representing ₹ 40 crores of general reserve and ₹ 5 crores of capital reserve acquired out of business combination and balance is surplus in the Retained Earnings.
- f) The company identified that the preference shares were in nature of financial liabilities.

What is the balance of total equity (Equity and other equity) as on 1st April, 20X1 after transition to Ind AS? Show reconciliation between total equity as per AS (Accounting Standards) and as per Ind AS to be presented in the opening balance sheet as on 1st April, 20X1. Ignore deferred tax impact. (8 Marks)

Solution

1. Computation of balance total equity as on 1st April, 20X1 after transition to Ind AS

			₹ in crore
Share capital- Equity share Capital			80
Other Equity			
General Reserve		40	
Capital Reserve		5	
Retained Earnings (95-5-40)	50		
Add: Increase in value of land (10-4.5)	5.5		
Add: De recognition of proposed dividend (0.6 + 0.18)	0.78		
Add: Increase in value of Investment	0.75	57.03	102.03
Balance total equity as on 1st April, 20X1 after transition to Ind AS			182.03

Reconciliation between Total Equity as per AS and Ind AS to be presented in the opening balance sheet as on 1st April, 20X1

		₹ in crore
Equity share capital		80
Redeemable Preference share capital		25
		105
Reserves and Surplus		95
Total Equity as per AS		200
Adjustment due to reclassification		
Preference share capital classified as financial liability		(25)
Adjustment due to derecognition		
Proposed Dividend not considered as liability as on 1 st April 20X1		0.78
Adjustment due to remeasurement		
Increase in the value of Land due to remeasurement at fair value	5.5	
Increase in the value of investment due to remeasurement at fair value	0.75	6.25
Equity as on 1st April, 20X1 after transition to Ind AS		182.03

Illustration 24

ABC Ltd is a government company and is a first-time adopter of Ind AS. As per the previous GAAP, the contributions received by ABC Ltd. from the government (which holds 100% shareholding in ABC Ltd.) which is in the nature of promoters' contribution have been recognised in capital reserve and treated as part of shareholders' funds in accordance with the provisions of AS 12, Accounting for Government Grants.

State whether the accounting treatment of the grants in the nature of promoters' contribution as per AS 12 is also permitted under Ind AS 20 Accounting for Government Grants and Disclosure of Government Assistance. If not, then what will be the accounting treatment of such grants recognised in capital reserve as per previous GAAP on the date of transition to Ind AS.

Solution

Paragraph 2 of Ind AS 20, "Accounting for Government Grants and Disclosure of Government Assistance" inter alia states that the Standard does not deal with government participation in the ownership of the entity.

Since ABC Ltd. is a Government company, it implies that government has 100% shareholding in the entity. Accordingly, the entity needs to determine whether the payment is provided as a shareholder contribution or as a government. Equity contributions will be recorded in equity while grants will be shown in the Statement of Profit and Loss.

Where it is concluded that the contributions are in the nature of government grant, the entity shall apply the principles of Ind AS 20 retrospectively as specified in Ind AS 101

"First Time Adoption of Ind AS". Ind AS 20 requires all grants to be recognised as income 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. Unlike AS 12, Ind AS 20 requires the grant to be classified as either a capital or an income grant and does not permit recognition of government grants in the nature of promoter's contribution directly to shareholders' funds.

Where it is concluded that the contributions are in the nature of shareholder contributions and are recognised in capital reserve under previous GAAP, the provisions of paragraph 10 of Ind AS 101 would be applied which states that except in certain cases, an entity shall in its opening Ind AS Balance Sheet:

- a) recognise all assets and liabilities whose recognition is required by Ind AS;
- b) not recognise items as assets or liabilities if Ind AS do not permit such recognition;
- c) reclassify items that it recognised in accordance with previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity in accordance with Ind AS; and
- d) apply Ind AS in measuring all recognised assets and liabilities.

Accordingly, as per the above requirements of paragraph 10(c) in the given case, contributions recognised in the Capital Reserve should be transferred to appropriate category under "Other Equity" at the date of transition to Ind AS.

Question 1 – (RTP May'21) (MTP March'22, Nov'22)

HIM Limited having net worth of ₹ 250 crores is required to adopt Ind AS from 1 April, 20X2 in accordance with the Companies (Indian Accounting Standard) Rules 2015.

Rahul, the senior manager, of HIM Ltd. has identified following issues which need specific attention of CFO so that opening Ind AS balance sheet as on the date of transition can be prepared:

Issue 1 : As part of Property, Plant and Equipment, Company has elected to measure land at its fair value and want to use this fair value as deemed cost on the date of transition. The carrying value of land as on the date of transition was ₹ 5,00,000. The land was acquired for a consideration of ₹ 5,00,000. However, the fair value of land as on the date of transition was ₹ 8,00,000.

Issue 2 : Under Ind AS, the Company has designated mutual funds as investments at fair value through profit or loss. The value of mutual funds as per previous GAAP was ₹ 4,00,000 (at cost). However, the fair value of mutual funds as on the date of transition was ₹ 5,00,000.

Issue 3 : Company had taken a loan from another entity. The loan carries an interest rate of 7% and it had incurred certain transaction costs while obtaining the same. It was carried at cost on its initial recognition. The principal amount is to be repaid in equal instalments over the period of loan. Interest is also payable at each year end. The fair value of loan as on the date of transition is ₹ 1,80,000 as against the carrying amount of loan which at present equals ₹ 2,00,000.

Issue 4 : The company has declared dividend of ₹ 30,000 for last financial year. On the date of transition, the declared dividend has already been deducted by the accountant from the company's 'Reserves & Surplus' and the dividend payable has been grouped under 'Provisions'. The dividend was only declared by board of directors at that time and it was not approved in the annual general meeting of shareholders. However, subsequently when the meeting was held it was ratified by the shareholders.

Issue 5 : The company had acquired intangible assets as trademarks amounting to ₹ 2,50,000. The company assumes to have indefinite life of these assets. The fair value of the intangible assets as on the date of transition was ₹ 3,00,000. However, the company wants to carry the intangible assets at ₹ 2,50,000 only.

Issue 6 : After consideration of possible effects as per Ind AS, the deferred tax impact is computed as ₹ 25,000. This amount will further increase the portion of deferred tax liability. There is no requirement to carry out the separate calculation of deferred tax on account of Ind AS adjustments.

Management wants to know the impact of Ind AS in the financial statements of company for its general understanding.

Prepare Ind AS Impact Analysis Report (Extract) for HIM Limited for presentation to the management wherein you are required to discuss the corresponding differences between Earlier IGAAP (AS) and Ind AS against each identified issue for preparation of transition date balance sheet. Also pass journal entry for each issue. (12 Marks)

Solution:**Preliminary Impact Assessment on Transition to Ind AS in HIM Limited's Financial Statements****Issue 1: Fair value as deemed cost for property plant and equipment:**

Accounting Standards (Earlier IGAAP)	Ind AS	Impact on Company's financial statements

As per AS 10, Property, Plant and Equipment is recognised at cost less depreciation.	Ind AS 101 allows entity to elect to measure Property, Plant and Equipment on the transition date at its fair value or previous GAAP carrying value (book value) as deemed cost.	The company has decided to adopt fair value as deemed cost in this case. Since fair value exceeds book value, so the book value should be brought up to fair value. The resulting impact of fair valuation of land ₹ 3,00,000 should be adjusted in other equity.

Journal Entry on the date of transition

Particulars	Debit (₹)	Credit (₹)
Property Plant and Equipment Dr.	3,00,000	
To Revaluation Surplus (OCI- Other Equity)		3,00,000

Issue 2: Fair valuation of Financial Assets:

Accounting Standards (Erstwhile IGAAP)	Ind AS	Impact on Company's financial statements
As per Accounting Standard, investments are measured at lower of cost and fair value.	On transition, financial assets including investments are measured at fair values except for investments in subsidiaries, associates and JVs' which are recorded at cost.	All financial assets (other than Investment in subsidiaries, associates and JVs' which are recorded at cost) are initially recognized at fair value. The subsequent measurement of such assets are based on its categorization either Fair Value through Profit & Loss (FVTPL) or Fair Value through Other Comprehensive Income (FVTOCI) or at Amortised Cost based on business model assessment and contractual cash flow characteristics. Since investment in mutual fund are designated at FVTPL, increase of ₹ 1,00,000 in mutual funds fair value would increase the value of investments with corresponding increase to Retained Earnings.

Journal Entry on the date of transition

Particulars	Debit (₹)	Credit (₹)
Investment in mutual funds Dr.	1,00,000	
To Retained earnings		1,00,000

Issue 3: Borrowings - Processing fees/transaction cost:

Accounting Standards (Erstwhile IGAAP)	Ind AS	Impact on Company's financial statements

As per AS, such expenditure is charged to Profit and loss account or capitalised as the case may be	As per Ind AS, such expenditure is amortised over the period of the loan. Ind AS 101 states that if it is impracticable 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.	Fair value as on the date of transition is ₹ 1,80,000 as against its book value of ₹2,00,000. Accordingly, the difference of ₹ 20,000 is adjusted through retained earnings.

Journal Entry on the date of transition

Particulars	Debit (₹)	Credit (₹)
Borrowings / Loan payable Dr.	20,000	
To Retained earnings		20,000

Issue 4: Proposed dividend:

Accounting Standards (Erstwhile IGAAP)	Ind AS	Impact on Company's financial statements
As per AS, provision for proposed dividend is made in the year when it has been declared and approved.	As per Ind AS, liability for proposed dividend is recognised in the year in which it has been declared and approved.	Since dividend should be deducted from retained earnings during the year when it has been declared and approved. Therefore, the provision declared for preceding year should be reversed (to rectify the wrong entry). Retained earnings would increase proportionately due to such adjustment

Journal Entry on the date of transition

Particulars	Debit (₹)	Credit (₹)
Provisions Dr.	30,000	
To Retained earnings		30,000

Issue 5 : Intangible assets:

Accounting Standards (Erstwhile IGAAP)	Ind AS	Impact on Company's financial statements
The useful life of an intangible asset cannot be indefinite under IGAAP principles. The Company amortised brand/trademark on a straight line basis over maximum of 10 years as per AS 26.	The useful life of an intangible asset like brand/trademark can be indefinite. Not required to be amortised and only tested for impairment. Company can avail the exemption given in Ind AS 101 as on the date of transition to use the carrying value as per previous GAAP.	Consequently, there would be no impact as on the date of transition since company intends to use the carrying amount instead of book value at the date of transition.

Issue 6: Deferred tax

Accounting Standards (Erstwhile IGAAP)	Ind AS	Impact on Company's financial statements
As per AS, deferred taxes are accounted as per income statement approach.	As per Ind AS, deferred taxes are accounted as per balance sheet approach.	On date of transition to Ind AS, deferred tax liability would be increased by ₹ 25,000.

Journal Entry on the date of transition

Particulars	Debit (₹)	Credit (₹)
Retained earnings Dr.	25,000	
To Deferred tax liability		25,000

Question 2 (Past Exam July21) (MTP May'23)

Government of India provides loans to MSMEs at a below-market rate of interest to fund the set-up of a new manufacturing facility. Sukshma Limited's date of transition to Ind AS is 1st April 2020.

In financial year 2014-2015, the Company had received a loan of ₹ 2.0 crore at a below - market rate of interest from the government. Under Indian GAAP, the Company had accounted for the loan as equity and the carrying amount was ₹ 2.0 crore at the date of transition. The amount repayable on 31st March 2024 will be ₹ 2.50 crore.

The Company has been advised to recognize the difference of ₹ 0.50 crores in equity by correspondingly increasing the value of various assets under property, plant & equipment by an equivalent amount on proportionate basis. Further, on 31st March 2024 when the loan has to be repaid, ₹ 2.50 crore should be presented as a deduction from property, plant & equipment.

Discuss the above treatment and share your views as per applicable Ind AS.

(6 Marks)**Solution:**

Requirement as per Ind AS:

A first-time adopter shall classify all government loans received as a financial liability or an equity instrument in accordance with Ind AS 32. A first-time adopter shall apply the requirements in Ind AS 109 and Ind AS 20, 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.

Treatment to be done:

Consequently, if a first-time adopter did not, under its previous GAAP, recognise and measure a government loan at a below-market rate of interest on a basis consistent with Ind AS requirements, it shall use its previous GAAP carrying amount of the loan at the date of transition to Ind AS as the carrying amount of the loan in the opening Ind AS Balance Sheet. An entity shall apply Ind AS 109 to the measurement of such loans after the date of transition to Ind AS.

In the instant case, the loan meets the definition of a financial liability in accordance with Ind AS 32. Company therefore reclassifies it from equity to liability. It also uses the previous GAAP carrying amount of the loan at the date of transition as the carrying amount of the loan in the opening Ind AS balance sheet.

It calculates the annual effective interest rate (EIR) starting 1st April 2020 as below: $EIR = \text{Amount} / \text{Principal}(1/t)$ i.e. $2.50/2(1/4)$ i.e. 5.74%. approx.

At this rate, ₹ 2 crore will accrete to ₹ 2.50 crore as at 31st March 2024.

During the next 4 years, the interest expense charged to statement of profit and loss shall be:

Year ended	Opening amortised cost (₹)	Interest expense for the year (₹) @ 5.74% p.a. approx.	Closing amortised cost (₹)
31st March 2021	2,00,00,000	11,48,000	2,11,48,000
31st March 2022	2,11,48,000	12,13,895	2,23,61,895
31st March 2023	2,23,61,895	12,83,573	2,36,45,468
31st March 2024	2,36,45,468	13,54,532	2,50,00,000

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.

The accounting treatment is to be done as per above guidance and the advice which the company has been provided is not in line with the requirements of Ind AS 101.

Question 3 - (RTP Dec'21), (MTP Nov'22)

While preparing an opening balance sheet on the date of transition, an entity is required to:

- recognise all assets and liabilities whose recognition is required by Ind AS;
- 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.

Give examples for each of the above 4 categories.

(5 Marks)

Solution

The examples of the items that an entity may need to recognise, derecognise, remeasure, reclassify on the date of transition are as under:

- recognise all assets and liabilities whose recognition is required by Ind AS:
 - customer related intangible assets if an entity elects to restate business combinations
 - share-based payment transactions with non-employees
 - recognition of deferred tax on land
- reclassify items that it recognised in accordance with previous GAAP as one type of asset, liability or component of equity, but is a different type of asset, liability or component of equity in accordance with Ind AS:
 - redeemable preference shares that would have earlier been classified as equity;
 - non-controlling interests which would have been earlier classified outside equity; and
- apply Ind ASs in measuring all recognised assets and liabilities:
 - discounting of long-term provisions
 - measurement of deferred income taxes for all temporary differences instead of timing differences

Question 4 (Past Exam – Dec 2021)

(This Question is same as Illustration 23, except that this question has 2 extra adjustments)

Rainy Pvt Ltd. is a company registered under the Companies Act, 2013 following Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006. The company has decided to present its first financials under Ind AS for the year ended 31st March, 2021. The transition date is 1st April, 2019.

The following adjustments were made upon transition to Ind AS:

- (i) The company opted to fair value its land as on the date on transition. The fair value of the land as on 1st April, 2019 was ₹ 95 lakh. The carrying amount as on 1st April, 2019 under the existing GAAP was ₹ 42.75 lakh.
- (ii) The company has recognised a provision for proposed dividend of ₹ 5.7 lakh and related dividend distribution tax of ₹ 1.65 lakh during the year ended 31st March, 2019. It was written back as on opening balance sheet date.
- (iii) The company had a non-integral foreign branch in accordance with AS 11 and had recognised a balance of ₹ 2 lakh as part of reserves. On first time adoption of Ind AS, the company intends to avail Ind AS exemption of resetting the cumulative translation difference to zero.
- (iv) The company had made an investment in subsidiary for ₹ 18.62 lakh that carried a fair value of ₹ 25.75 lakh as at the transition date. The company intends to recognise the investment at its fair value as at the date of transition.
- (v) The company has an Equity Share Capital of ₹ 760 lakh and Redeemable Preference Share Capital of ₹ 180 lakh. The company identified that the preference shares were in nature of financial liabilities.
- (vi) The Reserves and Surplus as on 1st April, 2019 before transition to Ind AS was ₹ 910 lakh representing ₹ 380 lakh of general reserve and ₹ 40 lakh of Capital Reserve acquired out of business combination and balance is surplus in the Retained Earnings.

What is the balance of total equity (Equity and other equity) as on 1st April, 2019 after transition to Ind AS? Show reconciliation between Total Equity as per AS (Accounting Standards) and as per Ind AS to be presented in the opening balance sheet as on 1st April, 2019. Ignore deferred tax impact. (8 Marks)

Solution:

(a) Computation of balance total equity as on 1st April, 2019 after transition to Ind AS

			₹ in lakh
Share capital- Equity share Capital			760.00
Other Equity			
General Reserve		380.00	
Capital Reserve		40.00	
Retained Earnings (910.00 – 380.00 – 40.00)	490.00		
Add: Increase in value of land (95.00 – 42.75)	52.25		
Add: Derecognition of proposed dividend (5.70 + 1.65)	7.35		
Add: Transfer of cumulative translation difference balance to retained earnings	2.00		
Add: Increase in value of Investment (25.75 – 18.62)	7.13	558.73	978.73
Balance total equity as on 1st April, 2019 after transition to Ind AS			<u>1,738.73</u>

Reconciliation between Total Equity as per AS and Ind AS to be presented in the opening balance sheet as on 1st April, 2019

		₹ in lakh
Equity share capital		760.00
Redeemable Preference share capital		<u>180.00</u>
		940.00
Reserves and Surplus		<u>910.00</u>

Total Equity as per AS		1,850.00
<i>Adjustment due to reclassification:</i>		
Preference share capital classified as financial liability		(180.00)
<i>Adjustment due to de-recognition:</i>		
Proposed dividend not considered as liability as on 1st April, 2019		7.35
<i>Adjustment due to re-measurement:</i>		
Increase in the value of Land due to re-measurement at fair value	52.25	
Resetting of cumulative translation difference balance to zero in Ind AS Transition date Balance Sheet	2.00	
Increase in the value of investment due to re-measurement at fair value	<u>7.13</u>	<u>61.38</u>
Equity as on 1st April, 2019 after transition to Ind AS		<u>1,738.73</u>

Question 5 (RTP May'22)

GG Ltd., a listed company, prepares its first Ind AS financial statements for the year ending 31st March, 20X3. The date of transition is 1st April, 20X1. The functional and presentation currency is Rupee. The financial statements as at and for the year ended 31st March, 20X3 contain an explicit and unreserved statement of compliance with Ind AS. Previously it was using Indian GAAP (AS) as base.

It has already published its first interim results of quarter 1, quarter 2 and quarter 3 of 20X2- 20X3 in accordance with Ind AS 34 and Ind AS 101. The interim financial report included the reconciliations both of total comprehensive income and of equity that are required by Ind AS 101.

Since issuing the interim financial report, its management has concluded that one of accounting policy choices applied at the interim should be changed for the full year.

How should GG Ltd. deal with the change in accounting policy under Ind AS framework?

Solution:

The first annual Ind AS financial statements are prepared in accordance with the specific requirements of Ind AS 101. Subject to certain specified exemptions and exceptions, paragraph 7 of Ind AS 101 requires the entity to use the same accounting policies in its opening Ind AS balance sheet and throughout all periods presented. This override Ind AS 8's requirements for disclosures about changes in accounting policies do not apply in an entity's first Ind AS financial statements.

GG Ltd. should include an explanation of the change in policy that it has made since the interim financial report, in the notes to the annual financial statements, in accordance with paragraph 27A of Ind AS 101. The disclosure note is likely to include information, similar to what Ind AS 8 would otherwise require, to help users of the financial statements to understand the changes that have been made. The entity should also ensure that the reconciliations of total comprehensive income and of equity, presented in the first Ind AS financial statements in accordance with paragraph 24 of Ind AS 101 are updated from those included in the interim financial report to reflect the amended accounting policy

Question 6 (MTP March'22)

G Ltd. operates oil exploration and production facilities. It is preparing its transition date opening balance sheet as per Ind AS.

There is a significant decommissioning obligation in connection with several oil wells, but its previous GAAP did not require the obligation to be recognized. Discuss the treatment of decommissioning obligation as per relevant Ind AS

(4 Marks)

Solution**De-commissioning Obligation of G Ltd. and recognition of decommissioning cost:**

Retrospective application of Ind AS 37 requires management to recognise the provision for decommissioning cost on the opening Ind AS Balance Sheet. The provision should reflect the net present value of the management's best estimate of the amount required to settle the obligation.

Accounting Treatment:

The obligation should be capitalised as a separate component of property, plant and equipment, together with the accumulated depreciation from the date when the obligation was incurred to the transition date. The amount to be capitalised as part of the cost of the asset is calculated by discounting the liability back to the date when the obligation initially arose, using the best estimate of historical discount rate. The associated accumulated depreciation is calculated by applying the current estimate of the asset's useful life, using the entity's depreciation policy for the asset.

Any difference between the provision and the related component of the property, plant and equipment is adjusted against the retained earnings.

The entity could elect to apply the deemed cost exemption. Property, plant and equipment would be restated to fair value, with the corresponding adjustment to the retained earnings. Management would need to ensure that the fair value obtained was the gross fair value and not net of the decommissioning obligation. Management would recognise the provision for decommissioning costs in accordance with Ind AS 37. No cost in respect of provision should be added to property, plant and equipment but such cost should be recognised in the entity's opening retained earnings.

Question 7 (MTP March'22)

G Ltd. has four assets, each in a different class under property, plant & equipment.

Assets 1 and 2 are revalued under previous GAAP (AS). Assets 3 and 4 are not. Under previous GAAP, at 31st March 20X1, immediately prior to the entity's date of transition to Ind AS, its Balance Sheet (extract) is as follows:

	Asset 1	Asset 2	Asset 3	Asset 4	Total
	Valuation	Valuation	Cost	Cost	
	₹	₹	₹	₹	₹
Cost or revaluation	5,000	2,000	4,000	4,500	15,500
Accumulated depreciation	(1,000)	(500)	(2,000)	(1,700)	(5,200)
Net book value	4,000	1,500	2,000	2,800	10,300
Revaluation surplus	2,500	500	-	-	3,000

On adoption of Ind AS, its management decides that, under Ind AS, it will:

- Continue to revalue asset 1. The fair value of asset 1 at the date of transition is not materially different from its carrying value under previous GAAP;
- Use the previous valuation of asset 2 as deemed cost, and adopt a policy of cost less depreciation under Ind AS;
- Adopt a policy of revaluation for asset 3. The fair value of asset 3 at the entity's date of transition is ₹ 5,000;
- Continue to use a policy of cost less depreciation for asset 4.

All depreciation methods are already in accordance with those required by Ind AS 16.

Discuss the treatment under Ind AS of valuation of assets 1, 2, 3 & 4, being part of property, plant & equipment?

(8 Marks)

Solution:

Measurement basis for valuation of PPE:

An entity has the following options with respect to measurement of its property, plant and equipment (Ind AS 16) in the opening Ind AS Balance Sheet:

- Measurement basis as per the respective standards applied retrospectively. This measurement option can be applied on an item-by-item basis. For example, Plant A can be measured applying Ind AS 16 retrospectively and Plant B can be measured applying the "fair value" or "revaluation" options mentioned below.
- Fair value at the date of transition to Ind AS. This measurement option can be applied on an item-by-item basis in similar fashion as explained above.
- Previous GAAP revaluation, if such revaluation was, at the date of revaluation, broadly comparable to (a) fair value or (b) cost or depreciated cost in accordance with other Ind AS adjusted to reflect changes in general or specific price index. This measurement option can be applied on an item-by-item basis in similar fashion as explained above.

Analysis of given case:

	Asset 1	Asset 2	Asset 3	Asset 4
Basis used in previous GAAP	Revaluation Model	Revaluation Model	Cost Model	Cost Model
Intent of G Ltd. on transition	To continue with Revaluation model	Use previous valuation as deemed cost	Adopt a policy of revaluation	Continue to use a policy of cost less depreciation
Treatment at the time of transition to Ind AS	Since fair value at the transition date is not materially different from its carrying value under previous GAAP, G Ltd. Can carry forward with revalued carrying value ₹ 4,000 as per previous GAAP in Ind AS books and continue to disclose a revaluation surplus of ₹ 2,500.	An entity may elect to measure an item of property, plant and equipment at the date of transition to Ind AS at its fair value and use that fair value as its deemed cost at that date. In Ind AS financial statements, asset will be carried forward at ₹ 1,500 and previously disclosed revaluation surplus is transferred to retained earnings or another component of equity.	Fair value at the date of transition to Ind AS is materially different from its carrying value under previous GAAP. The asset should be revalued and stated at its fair value of ₹ 5,000 on the date of transition to Ind AS. A revaluation surplus of ₹ 3,000 (5,000 – 2,000) will be transferred to revaluation reserve.	The entity is not availing any exemption given in Ind AS 101. The entity can measure applying Ind AS 16 retrospectively. It is assumed that measurement bases for cost of asset as per previous GAAP and Ind AS are same so asset will be shown in the Ind AS financial statements at ₹ 2,800.

Question 8 (RTP Nov'22)

On 1st April 20X1, Nuogen Ltd. had granted 1,20,000 share options to its employees with the vesting condition being a service condition as follows:

- Vesting date : 31st March 20X2 - 80,000 share options (1-year vesting period since grant date)
- Vesting date : 31st March 20X5 - 40,000 share options (4-year vesting period since grant date)

Each option can be converted into one equity share of Nuogen Ltd. The fair value of the options on grant date, i.e., on 1st April 20X1 was ₹ 20.

Nuogen Ltd. is required to prepare financial statements in Ind AS for the financial year ending 31st March 20X4. The transition date for Ind AS being 1st April 20X2.

The entity has disclosed publicly the fair value of both these equity instruments as determined at the measurement date, as defined in Ind AS 102.

The previous applicable GAAP for the entity was IGAAP (AS) and therein, the entity had not adopted intrinsic method of valuation.

The share options have not been yet exercised by the employees of Nuogen Ltd.

How the share based payment should be reflected in, the books of Nuogen Ltd. as on 31st March 20X4, assuming that the entity has erred by not passing any entry for the aforementioned transactions in the books of Nuogen Ltd. on grant date, i.e. 1st April 20X1?

Solution:

For 80,000 share-based options vested before transition date:

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**. Hence, Nuogen Ltd. may opt for the exemption given in Ind AS 101 for 80,000 share options vested before the transition date. However, since no earlier accounting was done for these share-based options under previous GAAP too, therefore this led to an error on the transition date, as detected on the reporting date i.e. 31st March, 20X4. Hence, being an error, no exemption could be availed by Nuogen Ltd. on transition date with respect to Ind AS 102.

While preparing the financial statements for the financial year 20X3 -20X4, 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. The error should be corrected by restating the opening balances of relevant assets and/or liabilities and relevant component of equity for the year 20X2-20X3. This will result in consequential restatement of balances as at 1st April, 20X2 (i.e, opening balance sheet as at 1st April, 20X2).

Accordingly, on retrospective calculation of Share based options with respect to 80,000 options, Nuogen Ltd. will create 'Share based payment reserve (equity)' by ₹ 16,00,000 and correspondingly adjust the same though Retained earnings.

For 40,000 share based options to be vested on 31st March, 20X5:

Since share-based options have not been vested before transition date, no option as per Ind AS 101 is available to Nuogen Ltd. The entity will apply Ind AS 102 retrospectively. However, Nuogen Ltd. did not account for the same at the grant date. This will result in consequential restatement of balances as at 1st April, 20X2 (i.e, opening balance sheet as at 1st April, 20X2). Adjustment is to be made by recognising the 'Share based payment reserve (equity)' and adjusting the retained earnings by ₹ 2,00,000.

Further, expenses for the year ended 31st March, 20X3 and share based payment reserve (equity) as at 31st March, 20X3 were understated because of non-recognition of 'employee benefits expense' and related reserve. To correct the above errors in the annual financial statements for the year ended 31st March, 20X4, the entity should restate the comparative amounts (i.e., those for the year ended 31 st March, 20X3) in the statement of profit and loss. In the given case, 'Share based payment reserve (equity)' would be credited by ₹ 2,00,000 and 'employee benefits expense' would be debited by ₹ 2,00,000

For the year ending 31st March, 20X4, 'Share based payment reserve (equity)' would be credited by ₹ 2,00,000 and 'employee benefits expense' would be debited by ₹ 2,00,000.

Working Note:

Period	Lot	Proportion	Fair value	Cumulative expenses	Expenses
		a	b	d = b x a	e = d - previous period d
20X1-20X2	1 (1-year vesting period)	1/1	16,00,000	16,00,000	16,00,000
20X1-20X2	2 (4-year vesting period)	1/4	8,00,000	2,00,000	2,00,000
20X2-20X3	2 (4-year vesting period)	2/4	8,00,000	4,00,000	2,00,000
20X3-20X4	2 (4-year vesting period)	3/4	8,00,000	6,00,000	2,00,000

Question 9 (RTP May 23)

ABC Ltd., a public limited company, is in the business of exploration and production of oil and gas and other hydrocarbon related activities outside India. It operates overseas projects directly and/or through subsidiaries, by participation in various joint arrangements and investment in associates. The company was following Accounting Standards as notified under the Companies (Accounting Standards) Rules until 31st March, 20X1. However, it has adopted Indian Accounting Standards (Ind AS) with effect from 1st April, 20X1.

The goodwill recognised in accordance with AS 21 and AS 27 was due to corporate structure and the line-by-line consolidation of subsidiaries/proportionate consolidation of jointly controlled entities' financial statements which was prepared on historical costs convention. ABC Ltd. has not taken into consideration the valuation of underlying oil and gas reserves for which excess amount (i.e. goodwill calculated as per the relevant AS requirements) has been paid by the company at the time of acquisition. The company further considered that in oil and gas companies, the goodwill generated on acquisition of mineral rights either through jointly controlled entities or subsidiaries, inherently derives its value from the underlying mineral rights and, accordingly, value of such goodwill depletes as the underlying mineral resources are extracted.

Therefore, taking a prudent approach and considering the above substance, the company amortised the goodwill in respect of its subsidiaries / jointly controlled assets over the life of the underlying mineral rights using Unit of Production method. This allowed the company to utilise the value of goodwill over the life of mineral rights and completely charging off the goodwill over the life of the reserves.

For financial year 20X0-20X1, the company has availed transition exemption under Ind AS 101 and has not applied the principles of Ind AS 103.

ABC Ltd. considering the substance over form of the goodwill to be in the nature of 'acquisition costs' intends to continue amortisation of the goodwill recognised under AS in respect of its subsidiaries / joint ventures (jointly controlled entities under AS) over the life of the underlying mineral rights using Unit of Production method, under Ind AS also post transition date.

Comment on appropriateness of the accounting treatment, under Ind AS, for amortisation of the goodwill by the company and state whether the accounting treatment in respect of amortisation of goodwill is correct or not.

Solution:

Point (g) of para C4 of Ind AS 101 states that the carrying amount of goodwill or capital reserve in the opening Ind AS Balance Sheet shall be its carrying amount in accordance with previous GAAP at the date of transition to Ind AS after the two adjustments. One of the adjustment states that the standard requires the first-time adopter to recognise an intangible asset that was subsumed in recognised goodwill or capital reserve in accordance with previous GAAP, the first-time adopter shall decrease the carrying amount of goodwill or increase the carrying amount of capital reserve accordingly (and, if applicable, adjust deferred tax and non-controlling interests)

As per the facts given, the entity paid excess amount to avail the rights to use the underlying oil and gas reserves. However, since the rights was not recorded in the books at that time, the value of goodwill subsumed the value of that intangible asset which should be separately identified in the books. Hence, value of goodwill will be reduced accordingly and intangible asset for rights for using mine should be recognised.

Further, regardless of whether there is any indication that the goodwill may be impaired, the first-time adopter shall apply Ind AS 36 in testing the goodwill for impairment at the date of transition to Ind AS and in recognising any resulting impairment loss in retained earnings (or, if so required by Ind AS 36, in revaluation surplus). The impairment test shall be based on conditions at the date of transition to Ind AS. No other adjustments (eg- previous amortisation of goodwill) shall be made to the carrying amount of goodwill / capital reserve at the date of transition to Ind AS.

However, once goodwill is recognised in the opening transition date balance sheet, the entity has to follow the provisions of Ind AS, which states that goodwill is not amortised but rather tested for impairment annually. Accordingly, the amortization of goodwill based on 'Unit of Production' method is not correct after implementation of Ind AS

Question 10 (Past exam Nov'23)

Diamond Limited is transitioning to Ind AS. It has certain investments in Ruby Limited's Convertible Debt Instruments, which are currently (on the date of transition to Ind AS) exercisable and would provide Diamond Limited with a controlling stake over Ruby Limited on exercise of the conversion rights. Diamond Limited evaluated that Ruby Limited should be treated as its subsidiary under Ind AS. Hence it would require consolidation in its Ind AS Consolidated Financial Statements. Ruby Limited was not considered as a Subsidiary, Associate or a Joint Venture under Previous GAAP. How should Ruby Limited be consolidated on transition to Ind AS. Assume that Diamond Limited has opted to avail the exemption from retrospective re-statement of past business combinations as per applicable Ind AS? **(5 Marks)**

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 applying the 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 amounts; 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.

IND AS 105 – NON-CURRENT ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS

Illustration 1

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 March, 20X1	₹
Cost	12,00,000
Depreciation	<u>(6,00,000)</u>
Net book value	<u>6,00,000</u>

The asset is depreciated at an annual rate of 10% ie. ₹1,20,000 p.a.

Entity ABC closes its books as on 31st March each year. During July, 20X1, entity ABC decides to sell the asset and on 1st August it meets the conditions to be classified as held for sale. Analyse what will be the treatment of the property in the books for the year 20X1-20X2.

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 ₹40,000 ($₹1,20,000 \times 4/12$) and should be carried at ₹ 5,60,000 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.

Illustration 2 (MTP Nov'23)

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.

Provide the accounting treatment of events for the year ending 31st March, 20X3 and 31st March, 20X4 and value the property at the end of 20X3 and 20X4. (8 Marks)

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	<u>(50,000)</u>	(5,20,000- 4,70,000)
Carrying Amount	<u>4,70,000</u>	

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.

Illustration 3

Identify whether each of the following scenarios gives rise to a discontinued operation and/or classification of assets as held for sale:

S. No	Particulars	Discontinued operation Yes/No	Assets held for sale Yes/No
1	MNO disposes of a component of the entity by selling the underlying assets. The sales transaction is incomplete at the reporting date.		
2	PQR has ceased activities that meet the definition of a discontinued operation without selling any assets.		
3	STU ceases activities and has already completed the sale of the underlying assets at the reporting date.		
4	VWX will sell or has sold assets that are within the scope of Ind AS 105, but does not discontinue any of its operations.		

Solution :

Discontinued operations and assets held for sale

S. No	Particulars	Discontinued operation Yes/No	Assets held for sale Yes/No
1	MNO disposes of a component of the entity by selling the underlying assets. The sales transaction is incomplete at the reporting date.	Yes	Yes
2	PQR has ceased activities that meet the definition of a discontinued operation without selling any assets.	Yes	No
3	STU ceases activities and has already completed the sale of the underlying assets at the reporting date.	Yes	No
4	VWX will sell or has sold assets that are within the scope of Ind AS 105, but does not discontinue any of its operations.	No	Yes

Illustration 4

Sun Ltd is a retailer of takeaway food like burger and pizzas. It decides to sell one of its outlets located in chandani chowk in New Delhi. The company will continue to run 200 other outlets in New Delhi.

All criteria mentioned in Ind AS 105 classification of assets as held for sale 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'. Analyse the opinion of the management with respect to the accounting treatment of the outlet.

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.

Illustration 5

On February 28, 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 March, 20X1?

Solution

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. The delay in the timing of the transfer of the property imposed by the Entity X demonstrates that the property is not available for immediate sale.

However, if the PPE meets the criteria for held for sale by 30th April, 20X1 (i.e., 2 months from 28th February, 20X1) and the accounts are not authorised by that date, then necessary disclosures need to be given in the financial statements.

Illustration 6

On March 1, 20X1, entity R decides to sell one of its factories. An agent is appointed and the factory is actively marketed. As on March 31, 20X1, it is expected that the factory will be sold by February 28, 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 June 26, 20X1. Should the factory be shown as held for sale as on March 31, 20X1?

Solution

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 March 31, 20X1.

Illustration 7 - (Past Exam Nov'19, MTP Nov'21)

On June 1, 20X1, entity X plans to sell a group of assets and liabilities, which is classified as a disposal group. On July 31, 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 November 30, 20X1 and the sale is expected to be completed by March 31, 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 December 31, 20X0	Carrying value as on July 31, 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	<u>(2,000)</u>	<u>(1,850)</u>
	<u>2,750</u>	<u>2,600</u>

The fair value of the manufacturing unit as on December 31, 20X0 is ₹2,000 and as on July 31, 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., December 31, 20X1. The fair value as on December 31, 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. **(10 Marks)**

Solution

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 July 31, 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 March 31, 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 July 31, 20X1 is determined at ₹ 2,600. The difference between the carrying value as on December 31, 20X0 and July 31, 20X1 is accounted for as per the relevant IND AS i.e., (IND AS 2 for inventory and IND AS 109 for debtors, creditors and loans).

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 July 31, 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 – July 31, 20X1	Impairment	Carrying value as per IND AS 105 – July 31, 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	<u>(1,850)</u>	<u>-</u>	<u>(1,850)</u>
	<u>2,600</u>	<u>(850)</u>	<u>1,750</u>

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.

Illustration 8 - (RTP May'18), (Past Exam May'22, Nov'23)

Following is the extract of the consolidated financial statements of A Ltd. for the year ended on:

Asset/ (liability)	Carrying amount as on 31 st March, 20X1 (In ₹ '000)
Attributed goodwill	200
Intangible assets	950
Financial asset measured at fair value through other comprehensive income	300
Property, plant & equipment	1100
Deferred tax asset	250
Current assets – inventory, receivables and cash balances	600
Current liabilities	(850)
Non-current liabilities – provisions	<u>(300)</u>
Total	2,250

On 15th September 20X1, Entity A decided to sell the business. It noted that the business meets the condition of disposal group classified as held for sale on that date in accordance with Ind AS 105. However, it does not meet the conditions to be classified as discontinued operations in accordance with that standard.

The disposal group is stated at the following amounts immediately prior to reclassification as held for sale.

Asset/ (liability)	Carry amount as on 15 th September 20X1 (In ₹ '000)

Attributed goodwill	200
Intangible assets	930
Financial asset measured at fair value through other comprehensive income	360
Property, plant & equipment	1,020
Deferred tax asset	250
Current assets – inventory, receivables and cash balances	520
Current liabilities	(870)
Non-current liabilities – provisions	(250)
Total	2,160

Entity A proposed to sell the disposal group at ₹19,00,000. It estimates that the costs to sell will be ₹70,000. This cost consists of professional fee to be paid to external lawyers and accountants.

As at 31st March 20X2, there has been no change to the plan to sell the disposal group and entity A still expects to sell it within one year of initial classification. Mr. X, an accountant of Entity A remeasured the following assets/ liabilities in accordance with respective standards as on 31st March 20X2:

Available for sale:	(In ₹ '000)
Financial assets	410
Deferred tax assets	230
Current assets- Inventory, receivables and cash balances	400
Current liabilities	900
Non- current liabilities- provisions	250

The disposal group has not been trading well and its fair value less costs to sell has fallen to ₹ 16,50,000.

Required:

What would be the value of all assets/ liabilities within the disposal group as on the following dates in accordance with Ind AS 105?

- (a) 15 September, 20X1 and
(b) 31st March, 20X2

(8 Marks)

Solution

(a) As at 15 September, 20X1

The disposal group should be measured at ₹ 18,30,000 (19,00,000-70,000). The impairment write down of ₹3,30,000 (₹ 21,60,000 – ₹ 18,30,000) should be recorded within profit from continuing operations.

The impairment of ₹3,30,000 should be allocated to the carrying values of the appropriate non-current assets.

Asset/ (liability)	Carrying value as at 15 th Sept 20X4	Impairment	Revised carrying value as per IND AS 105
Attributed goodwill	200	(200)	-
Intangible assets	930	(62)	868
Financial asset measured at fair value through other comprehensive income	360	-	360
Property, plant & equipment	1,020	(68)	952
Deferred tax asset	250	-	250
Current assets – inventory, receivables and cash balances	520	-	520

Current liabilities	(870)	-	(870)
Non-current liabilities – provisions	(250)	-	(250)
Total	2,160	(330)	1,830

The impairment loss is allocated first to goodwill and then pro rata to the other assets of the disposal group within Ind AS 105 measurement scope. Following assets are not in the measurement scope of the standard- financial asset measured at other comprehensive income, the deferred tax asset or the current assets. In addition, the impairment allocation can only be made against assets and is not allocated to liabilities.

(b) As on 31 March, 20X2:

All of the assets and liabilities, outside the scope of measurement under IND AS 105, are remeasured in accordance with the relevant standards. The assets that are remeasured in this case under the relevant standards are the Financial asset measured at fair value through other comprehensive income (Ind AS 109), the deferred tax asset (Ind AS 12), the current assets and liabilities (various standards) and the non-current liabilities (Ind AS 37).

Asset/ (liability)	Carrying amount as on 15 September, 20X1	Change in value to 31 st March 20X2	Impairment	Revised carrying value as per Ind AS 105
Attributed goodwill	-	-	-	-
Intangible assets	868	-	(29)	839
Financial asset measured at fair value through other comprehensive income	360	50	-	410
Property, plant & equipment	952	-	(31)	921
Deferred tax asset	250	(20)	-	230
Current assets – inventory, receivables and cash balances	520	(120)	-	400
Current liabilities	(870)	(30)	-	(900)
Non-current liabilities – provisions	(250)	-	-	(250)
Total	1,830	(120)	(60)	1,650

Illustration 9 – (RTP – May 2019)

CK Ltd. prepares the financial statement under Ind AS for the quarter year ended 30th June, 20X1. During the 3 months ended 30th June, 20X1 following events occurred:

On 1st April, 20X1, the Company has decided to sell one of its divisions as a going concern following a recent change in its geographical focus. The proposed sale would involve the buyer acquiring the non-monetary assets (including goodwill) of the division, with the Company collecting any outstanding trade receivables relating to the division and settling any current liabilities.

On 1st April, 20X1, the carrying amount of the assets of the division were as follows:

- Purchased Goodwill – ₹ 60,000
- Property, Plant & Equipment (average remaining estimated useful life two years) - ₹ 20,00,000
- Inventories - ₹ 10,00,000

From 1st April, 20X1, the Company has started to actively market the division and has received number of serious enquiries. On 1st April, 20X1 the directors estimated that they would receive Rs. 32,00,000 from

the sale of the division. Since 1st April, 20X1, market condition has improved and as on 1st August, 20X1 the Company received and accepted a firm offer to purchase the division for ₹ 33,00,000.

The sale is expected to be completed on 30th September, 20X1 and ₹ 33,00,000 can be assumed to be a reasonable estimate of the value of the division as on 30th June, 20X1. During the period from 1st April to 30th June inventories of the division costing ₹ 8,00,000 were sold for ₹ 12,00,000. At 30th June, 20X1, the total cost of the inventories of the division was ₹ 9,00,000. All of these inventories have an estimated net realisable value that is in excess of their cost.

Suggest how the proposed sale of the division will be reported in the interim financial statements for the quarter ended 30th June, 20X1 giving relevant explanations.

Solution

The decision to offer the division for sale on 1st April, 20X1 means that from that date the division has been classified as held for sale. The division available for immediate sale, is being actively marketed at a reasonable price and the sale is expected to be completed within one year.

The consequence of this classification is that the assets of the division will be measured at the lower of their existing carrying amounts and their fair value less cost to sell. Here the division shall be measured at their existing carrying amount i.e. ₹ 30,60,000 since it is less than the fair value less cost to sell ₹ 32,00,000.

The increase in expected selling price will not be accounted for since earlier there was no impairment to division held for sale.

The assets of the division need to be presented separately from other assets in the balance sheet. Their major classes should be separately disclosed either on the face of the balance sheet or in the notes.

The Property, Plant and Equipment shall not be depreciated after 1st April, 20X1 so its carrying value at 30th June, 20X1 will be ₹ 20,00,000 only. The inventories of the division will be shown at ₹ 9,00,000.

The division will be regarded as discontinued operation for the quarter ended 30th June, 20X1. It represents a separate line of business and is held for sale at the year end.

The Statement of Profit and Loss should disclose, as a single amount, the post-tax profit or loss of the division on classification as held for sale.

Further, as per Ind AS 33, EPS will also be disclosed separately for the discontinued operation.

Illustration 10 (MTP April'22)

Identify which of the following is a disposal group at 31 March 20X1:

1. On 21 March 20X1, XYZ announced the Board's intention to sell its shares in a subsidiary company, Alpha, contingent upon the approval of Alpha's shareholders. It seems unlikely that approval will be granted in the near future and no specific potential buyer has been identified.
2. PQR has entered into a contract to sell the entire delivery fleet of vehicles operated from its warehouse to a competitor, ABC, on 14 March 20X1. The assets will be transferred on 28 April 20X1 from which date the Group will outsource its delivery activities to another company, LMN.
3. On 16 January 20X1, DEF's management and shareholders approved a plan to sell its retail business in Mumbai and a consultant is hired to manage the sale. As at 31 March 20X1 heads of agreement had been signed although due diligence and the negotiation of final terms are still in process. The transaction is expected to be completed in April 20X1.

(6 Marks)

Solution:

Presented as held for sale

- (2) PQR's fleet is classified as held for sale because it constitutes a group of assets to be sold in their present condition and the sale is highly probable at the reporting date (as a contract has been entered into).
- (3) DEF's sale of its retail business will not be completed until the final terms (e.g. of purchase price) are agreed. However, the business is ready for immediate sale and the sale is highly probable unless other evidence after the reporting date but before the financial statements are approved for issue, comes to light to indicate the contrary.

Not presented as held for sale

- (1) XYZ's shares in Alpha are not available for an immediate sale as shareholders' approval is required. Also no specific potential buyer has been identified. In taking these fact into consideration for the assessment of whether the sale is highly probable, it is clearly not highly probable.

Question 1 - (Past Exam Nov'18, May'23)

PB Limited purchased a plastic bottle manufacturing plant for ₹ 24 lakh on 1st April, 2015. The useful life of the plant is 8 years. The depreciation is provided on straight line method. On 30th September, 2017, PB Limited 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 PB Limited decided to treat the plant as held for sale until the demand picks up and accordingly measures the plant at lower of carrying amount and fair value less cost to sell. The accountant has also stopped charging depreciation for rest of the period considering the plant as held for sale. The fair value less cost to sell on 30th September, 2017 and 31st March, 2018 was ₹ 13.5 lakh and ₹ 12 lakh respectively.

The accountant has made the following working:

Carrying amount on initial classification as held for sale		
Purchase price of Plant	24,00,000	
Less: Accumulated Depreciation [(₹ 24,00,000/8)x2.5 years]	7,50,000	16,50,000
Fair value less cost to sell as on 30th September, 2017		13,50,000
The value lower of the above two		13,50,000

Balance Sheet extracts as on 31st March, 2018

Particulars	₹
Assets	
Current Assets	
Other Current Assets	
Assets classified as held for sale	12,00,000

Required:

Analyze whether the above accounting treatment is in compliance with the Ind AS. If not, advise the correct treatment showing necessary workings. Provide balance sheet extract as at 31st March, 2018 together with the computation of the carrying value of Plant as at 31st March, 2018 **(8 Marks)**

Solution

As per Ind AS 105 'Non-current Assets Held for Sale and Discontinued Operations', an entity shall classify a non-current asset as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.

For asset to be classified as held for sale, it must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets and its sale must be highly probable. In such a situation, an asset cannot be classified as a non-current asset held for sale, if the entity intends to sell it in a distant future.

For the sale to be highly probable, the appropriate level of management must be committed to a plan to sell the asset, and an active programme to locate a buyer and complete the plan must have been initiated. Further, the asset 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.

Further Ind AS 105 also states that an entity shall not classify as held for sale a non-current asset that is to be abandoned. This is because its carrying amount will be recovered principally through continuing use.

An entity shall not account for a non-current asset that has been temporarily taken out of use as if it had been abandoned.

In addition to Ind AS 105, 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.

The Accountant of PB 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. PB 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 will be as follows:

Calculation of carrying amount as on 31 st March, 2018	₹
Purchase Price of Plant	24,00,000
Less: Accumulated depreciation (24,00,000/ 8 years) x 3 years	(9,00,000)
Carrying amount before impairment	15,00,000
Less: Impairment loss (Refer Working Note)	(3,00,000)
Revised carrying amount after impairment	12,00,000

Balance Sheet extracts as on 31st March 2018

Assets	₹
Non-Current Assets	
Property, Plant and Equipment	12,00,000

Working Note:

Fair value less cost to sell of the Plant = ₹ 12,00,000

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. ₹ 12,00,000

Impairment loss = Carrying amount – Recoverable amount

Impairment loss = ₹ 15,00,000 - ₹ 12,00,000 = ₹ 3,00,000.

Question 2 – (RTP Dec 2021)

On February 28, 20X1, Entity X is committed to the following plans:

- To sell a property after completion of 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.
- To sell a commercial building to a buyer after the occupant vacates the building. The time required for vacating the building is usual and customary for sale of such commercial property. The entity considers the sale to be highly probable.

Can the above-mentioned property and commercial building be classified as non-current assets held for sale at the reporting date i.e. 31st March, 20X1?

Solution

Ind AS 105 provides guidance on classification of a non-current asset held for sale in paragraph 7 which states that, 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.

- In respect of Entity X's plan to sell property which is being renovated and such renovation is incomplete as at the reporting date. Although, the renovations are expected to be completed within 2 months from the reporting date i.e., March 31, 20X1, the property cannot be classified as held for sale at the reporting date as it is not available for sale immediately in its present condition.
- In case of Entity X's plan to sell commercial building, it intends to transfer the commercial building to a buyer after the occupant vacates the building and the time required for vacating such building is usual

and customary for sale of such non-current asset. Accordingly, the criterion of the asset being available for immediate sale would be met and hence, the commercial building can be classified as held for sale at the reporting date.

Question 3 (RTP May'22)

X Ltd. acquires B Ltd. exclusively with a view to sale and it meets the criteria to be classified as discontinued operation as per Ind AS 105. Further, following information is available about B Ltd.:

Fair value of total assets excluding liabilities on acquisition – ₹ 360 Costs to sell as on acquisition and on reporting date – ₹ 10

Fair value of liabilities on acquisition and reporting date – ₹ 80

Fair value of total assets excluding liabilities on the reporting date – ₹ 340

How discontinued operation pertaining to B Ltd. should be measured in consolidated financial statements of X Ltd. on acquisition date and reporting date?

Solution:

Ind AS 105 defines a disposal group as 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. The group includes goodwill acquired in a business combination if the group is a cash-generating unit to which goodwill has been allocated in accordance with the requirements of paragraphs 80–87 of Ind AS 36, Impairment of Assets, or if it is an operation within such a cash-generating unit.

In the given case, B Ltd. is acquired exclusively with a view to sell and meets the criteria to be classified as discontinued operation.

The discontinued operation would be measured in accordance with paragraphs 15 and 16 of Ind AS 105

As per para 15, 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.

As per para 16, if a newly acquired asset (or disposal group) meets the criteria to be classified as held for sale (see paragraph 11), applying paragraph 15 will result in the asset (or disposal group) being 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 shall be measured at fair value less costs to sell.

Therefore, on acquisition date, in line with paragraph 16, X Ltd. will measure B Ltd. as a disposal group at fair value less costs to sell which will be calculated as Fair value of total assets excluding liabilities on acquisition – Costs to sell = ₹ 360 – ₹ 10 = ₹ 350.

Fair value of liabilities on acquisition = ₹ 80.

At the reporting date, in line with paragraph 15, X Ltd. will remeasure the disposal group at the lower of its cost and fair value less costs to sell which will be calculated as:

Fair value of total assets excluding liabilities on subsequent reporting date – Costs to sell

= ₹ 340 – ₹ 10 = ₹ 330

Fair value of liabilities on reporting date = ₹ 80.

At the reporting date, X Ltd. shall present these assets and liabilities separately from other assets and liabilities in its consolidated financial statements.

In the statement of profit and loss, X Ltd. shall recognise loss on subsequent measurement (of net assets at fair value) of B Ltd. which equals to ₹ 20 (₹ 270 – ₹ 250).

Question 4 (RTP Nov'22)

Company A has financial year ending 31st March, 20X0. On 1st June, 20X0, the Company has classified its Division B as held for sale in accordance with Ind AS 105. How property, plant and equipment (PPE) for which the company has adopted cost model shall be measured immediately before the classification as held for sale on 1st June, 20X0?

Solution:

Paragraph 18 of Ind AS 105 provides that 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.

In the instant case, Company A should measure the property, plant and equipment (for which it has adopted cost model), in accordance with Ind AS 16, Property, Plant and Equipment. Hence, depreciation should be provided upto 31st May, 20X0.

Question 5 (RTP May'23)

Note: This Ques is similar to illus 9 of IND AS 105, the only difference is that, in illus 9 there was no impairment loss but in this illustration there is impairment loss.

On 1st January, 20X1, the carrying amounts of the relevant assets of the division of an entity, Star Ltd. were as follows:

- ❖ Purchased goodwill ₹ 1.2 lakhs;
- ❖ Property, plant and equipment (average remaining estimated useful life two years) ₹ 4 lakhs;
- ❖ Inventories ₹ 2 lakhs.

From 1st January, 20X1, Star Ltd. began to actively market the division and has received a number of serious enquiries.

On 1st January, 20X1, the directors estimated that they would receive ₹ 6.4 lakhs from the sale of the division. Since 1st January, 20X1, market conditions have improved and on 30th April, 20X1, Star Ltd. received and accepted a firm offer to purchase the division for ₹ 6.6 lakhs. The sale is expected to be completed on 30th June, 20X1.

₹ 6.6 lakhs can be assumed to be a reasonable estimate of the value of the division on 31st March, 20X1.

During the period from 1st January 20X1 to 31st March, 20X1, inventories of the division costing ₹ 1.6 lakhs were sold for ₹ 2.4 lakhs. At 31st March, 20X1, the total cost of the inventories of the division was ₹ 1.8 lakhs. All of these inventories have an estimated net realizable value that is in excess of their cost.

Explain the disclosure requirement related to sale of division and provide the accounting treatment of property held for sale and discontinued operations.

Solution:

The decision to offer the division for sale on 1st January, 20X1 means that from that date the division is classified as held for sale. The division available for immediate sale, is being actively marketed at a reasonable price, and the sale is expected to be completed within one year.

The consequence of this classification is that the assets of the division will be measured at the lower of their existing carrying amounts (₹ 7.20 lakhs i.e. Goodwill ₹ 1.2 lakh + PPE ₹ 4 lakhs + Inventory ₹ 2 lakhs) and their fair value less costs to sell (₹ 6.40 lakhs). This implies that the assets of the division will be measured at ₹ 6.40 lakhs on 1st January, 20X1.

The reduction in carrying value of the assets of ₹ 0.80 lakhs (₹ 7.20 lakhs – ₹ 6.40 lakhs) will be treated as an impairment loss and allocated to goodwill, leaving a carrying amount for goodwill of ₹ 0.40 lakhs (₹ 1.20 lakhs – ₹ 0.80 lakhs).

The increased expectation of the selling price of ₹ 0.20 lakhs (₹ 6.60 lakhs – ₹ 6.40 lakhs) will be treated as a reversal of an impairment loss. However, since this reversal relates to goodwill, it cannot be recognised.

The assets of the division need to be presented separately from other assets in the balance sheet. Their major classes of assets classified as held for sale should be separately disclosed, either in the balance sheet or in the notes.

The property, plant and equipment should not be depreciated after 1st January, 20X1, so its carrying value at 31st March, 20X1 will be ₹ 4 lakhs. The inventories of the division will be shown at their year-end cost of ₹ 1.80 lakhs.

The division will be regarded as a discontinued operation for the year ended 31st March, 20X1. It will represent a separate line of business and will be held for sale at the year end.

The statement of profit and loss should disclose, as a single amount, the post-tax profit or loss of the division and the impairment loss arising on the re-measurement of the division on classification as held for sale. Further analysis of this single amount 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 shall be presented in a section identified as relating to discontinued operations, i.e. separately from continuing operations.

Question 6 (RTP Nov'23)

Company X has identified one of its division (disposal group) to be sold to a prospective buyer and the Board has approved the plan to sell the division on 30th September, 20X1. The sale is expected to complete after one year but it still qualifies to be held for sale under Appendix B of Ind AS 105. Costs to sell the division is estimated to be ₹ 10 crores (to be incurred in March, 20X3). The fair value of the division is ₹ 400 crores (on 30th September, 20X1 and 31st March, 20X2) and carrying value is ₹ 500 crores.

How shall such a division (disposal group) be measured under Ind AS 105 on following reporting dates:

- A. 30th September, 20X1
- B. 31st March, 20X2

Consider the discounting factor @ 10% for 1 year to 0.909 and for 1.5 years to be 0.867.

Solution:

Paragraph 15 of Ind AS 105 states that 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.

Further, paragraph 17 of Ind AS 105 states that when the sale is expected to occur beyond one year, the entity shall 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.

Company X has identified a disposal group and is committed to sell the same. The sale is expected to be completed after a period of one year hence, it will measure the costs to sell such disposal group at present value as per paragraph 17 of Ind AS 105.

A. On 30th September, 20X1

The disposal group will be measured at fair value less costs to sell which will be as follows:

Fair value:	₹ 400.00 crores	
PV of costs to sell:	(₹ 8.67 crores)	(₹ 10 crores x 0.867)
Total:	₹ 391.33 crores	

B. On 31st March, 20X1

The disposal group will be measured at fair value less costs to sell which will be as follows:

Fair value:	₹ 400.00 crores	
PV of costs to sell:	(₹ 9.09 crores)	(10 x 0.909)
Total:	₹ 390.91 crores	

The increase in costs to sell the division by ₹ 0.42 crore (₹ 9.09 crores – ₹ 8.67 crores) will be recognised in profit and loss as financing cost in accordance with paragraph 17 of Ind AS 105.

SOLVED EXAMPLE

Example 1: 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 recognise 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'.

Example 2: Reversal of Impairment Losses

A freehold property was originally acquired for ₹ 40,00,000. Some years later, after cumulative depreciation of ₹ 11,00,000 has been recognised, an impairment loss of ₹ 3,50,000 is recognised, taking the carrying amount to ₹ 25,50,000, which represents the estimated value in use of the property. Shortly thereafter, as a consequence of a proposed move to new premises, the freehold property is classified as held for sale.

At the time of classification as held for sale:

- ✓ carrying amount is ₹ 25,50,000; and
- ✓ fair value less costs to sell is assessed at ₹ 25,00,000.

Accordingly, the initial write-down on classification as held for sale is ₹ 50,000 and the property is carried at ₹ 25,00,000. Following classification as held for sale, no further depreciation is recognised.

At the next reporting date, the property market has improved and fair value less costs to sell is reassessed at ₹ 26,50,000. The gain of ₹ 1,50,000 is less than the cumulative impairment losses recognised to date (₹ 3,50,000 + ₹ 50,000 = ₹ 4,00,000). Accordingly, it is credited in profit or loss and the property is carried at ₹ 26,50,000.

Six months after that, the property market has continued to improve, and fair value less costs to sell is now assessed at ₹ 30,00,000. This further gain of ₹ 3,50,000 is, however, in excess of the cumulative impairment losses recognised to date (₹ 3,50,000 + ₹ 50,000 – ₹ 1,50,000 = ₹ 2,50,000). Accordingly, a restricted gain of ₹ 2,50,000 is credited in profit or loss and the property is carried at ₹ 29,00,000.

Subsequently, the property is sold for ₹ 30,00,000, at which time a gain of ₹ 1,00,000 is recognised.

IND AS 108 – OPERATING SEGMENTS

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.

Illustration 2

The CEO along with other Board members do a review of financial information about various business segments and take decisions on the basis of discrete information available for these segments and are correctly identified as Chief Operating Decision Maker (CODM). Review of only revenue information is done for decision making about those segments by the CODM. As per CODM, many segments require minimal costs due to centralization of costs. Whether review of only the revenue related information is sufficient for these segments to be considered as operating segments for the purposes of Ind AS 108 'Operating Segments'?

Solution

Many entities would be considering the decision making for segments on the basis of revenue growth – especially the ones aggressively trying to build a market share. Common examples would be businesses into technology sector or those creating or launching new products from time to time. For them, the decision making for different regional segments would need revenue growth and related information for further investment decision.

Merely examining revenue data by CODM without taking into account the corresponding expenses involved in generating that revenue may not provide adequate insights for determining how to allocate resources and measure the performance of a segment.

However, in the instant case, the logic given by the CODM is that since many segments require minimal costs (due to centralization of costs), therefore, revenue-only data is a fair representation of the operating results.

In the above case, review of the information that is based only on revenue data may be appropriate to consider that the segment meets the definition of an operating segment.

Illustration 3

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.

Illustration 4

CODM of XY Ltd. receives and reviews multiple sets of information when assessing the businesses' overall performance to take a decision on resources allocation. It receives the information as under:

- Level 1 Report: Summary report for all 4 regions
- Level 2 Report: Summary report for 20 Sub-regions within those regions
- Level 3 Report: Detailed report for 50 Branches within the sub-regions

What factors and level should be considered for determining an operating segment?

Solution

We need to consider multiple factors (including but not limited to below):

- The process that CODM may use to assess the performance (Key Financial Matrix, KPIs, Ratio etc.);
- Identify the segment managers and their responsibility areas;
- The process of budgeting for resource allocations.

Illustration 5

XY Ltd. has operations in France, Italy, Germany, UK and India. It wishes to apply aggregation criteria on geographical basis.

How will the aggregation criteria apply for reporting segments in the given scenario?

Solution

XY Ltd. needs to assess and prove that each country possesses the same economic characteristics. Factors including exchange control regulations, currency risks and economic conditions are required to be considered.

Considering above factors, it may be possible to aggregate the results of France, Italy and Germany (falling within EU region) and results of UK and India may be separately reported (no aggregation is permitted).

Illustration 6

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. State whether X Ltd. should 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.

Illustration 7 - (MTP – March 2021)

T Ltd is engaged in transport sector, running a fleet of buses at different routes. T Ltd has identified 3 operating segments:

- Segment 1: Local Route
- Segment 2: Inter-city Route
- Segment 3: Contract Hiring

The characteristics of each segment are as under:

Segment 1: The local transport authority awards the contract to ply the buses at different routes for passengers. These contracts are awarded following a competitive tender process; the ticket price paid by passengers are controlled by the local transport authority. T Ltd would charge the local transport authority on a per kilometer basis.

Segment 2: T Ltd operates buses from one city to another, prices are set by T Ltd on the basis of services provided (Deluxe, Luxury or Superior).

Segment 3: T Ltd also leases buses to schools under a long-term arrangement.

While Segment 1 has been showing significant decline in profitability, Segment 2 is performing well in respect of higher revenues and improved margins. The management of the company is not sure why is the segment information relevant for users when they should only be concerned about the returns from overall business. They would like to aggregate the Segment 1 and Segment 2 for reporting under 'Operating Segment'

Required:

Whether it is appropriate to aggregate Segments 1 and 2 with reference to Ind AS 108 'Operating Segments'? and

Discuss, in the above context, whether disclosure of segment information is relevant to an investor's appraisal of financial statements? **(6 Marks)**

Solution

Ind AS 108 'Operating Segments' requires operating segments to be aggregated to present a reportable segment if the segments have similar economic characteristics, and the segments are similar in each of the following aggregation criteria:

- (a) The nature of the products and services
- (b) The nature of the production process
- (c) The type or class of customer for their products and services
- (d) The methods used to distribute their products or provide their services
- (e) If applicable, the nature of the regulatory environment

While the products and services are similar, the customers for those products and services are different.

In Segment 1, the decision to award the contract is in the hands of the local authority, which also sets prices and pays for the services. The company is not exposed to passenger revenue risk, since a contract is awarded by competitive tender.

On the other hand, in the inter-city segment, the customer determines whether a bus route is economically viable by choosing whether or not to buy tickets. T Ltd sets the ticket prices but will be affected by customer behavior or feedback. T Ltd is exposed to passenger revenue-risk, as it sets prices which customers may or may not choose to pay.

Operating Segment provides information that makes the financial statements more useful to investors. In making the investment decisions, investors and creditors consider the returns they are likely to make on their investment. This requires assessment of the amount, timing and uncertainty of the future cash flows of

T Ltd as well as of management's stewardship of T Ltd's resources. How management derives profit is therefore relevant information to an investor.

Inappropriately aggregating segments reduces the usefulness of segment disclosures to investors. Ind AS 108 requires information to be disclosed that is not readily available elsewhere in the financial statements, therefore it provides additional information which aids an investor's understanding of how the business operates and is managed.

In T Ltd.'s case, if the segments are aggregated, then the increased profits in segment 2 will hide the decreased profits in segment 1. However, the fact that profits have sharply declined in segment 1 would be of interest to investors as it may suggest that future cash flows from this segment are at risk.

It is not mandatory to aggregate segments. An entity, if desires, can disclose separately information about segments that meet all the criteria. However, with regard to upper limit on number of segments to be reported, the entity should consider whether a practical limit has been reached.

Illustration 8

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 be separately reportable since they meet all three size criteria, though anyone 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.

Illustration 9

An entity has branches in different parts of the country – catering to different customers and selling local made products (a product of one region is not sold in any other region). No region or product contributes more than 5% to total revenue of the entity.

Discuss how many segments are reportable?

Solution

Under the quantitative threshold, external revenue of reportable segments must be $\geq 75\%$ of total external revenue of the entity. Considering above case, minimum 15 operating segments need to be reportable ($75\% \text{ [threshold]} / 5\% \text{ {revenue}} \}$).

Illustration 10

GH Ltd. has four distinct operating segments. The management of GH is concerned as it is unsure on how common costs be reasonably allocated to different operating segments. They intend to allocate management charges, interest costs of internal funding, cost of management of properties and pension costs.

Whether such costs need to conform to the accounting policies as used to prepare the financial statements?

Solution

Ind AS 108 does not prescribe any specific basis but suggests that a reasonable basis to be used in allocation of common costs. Here, it may not be reasonable to allocate management charges to most profitable segment. However, it may be reasonable to charge interest costs of internal funding on the basis of actual usage over time, even if majority of funds are used for running a loss-making segment.

A reasonable manner of allocation of above costs could be:

Management Charges: These may be allocated based on Net Assets invested or Revenue earned by the segments. It needs to be understood if there is an operating segment which is yet to earn revenue, it would fail to have any costs being allocated.

Interest costs: As mentioned above, these may be allocated on the basis of actual usage and time.

Cost of management of properties: Based on value of property used at each segment.

Pension costs: Based on salary expenses of each segment.

Illustration 11 – (Past Exam – Nov 2020)

X Ltd. has identified 4 operating segments for which revenue data is given below:

	External Revenue (₹)	Internal Revenue (₹)	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 Revenue	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? **(6 Marks)**

Solution:

Threshold amount is ₹ 10,00,000 ($₹ 1,00,00,000 \times 10\%$).

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% ($₹ 35,00,000/50,00,000 \times 100$) 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% ($₹ 43,50,000/50,00,000 \times 100$) of total entity revenues.

In this situation, Segments A, C and D will be reportable segments and Segment B will be shown as other segment.

Alternatively, segment B can be considered as a reportable segment as well as it meets the definition of operating segment. If Segment B is considered as reportable segment:

External revenue reported: ₹ 30,00,000 + ₹ 6,50,000 + ₹ 5,00,000 = ₹ 41,50,000

% of Total External Revenue = ₹ 41,50,000 / ₹ 50,00,000 = 83%

Accordingly, Segments A, B and D will be reportable segments and Segment C will be shown as other segment.

Illustration 12 – (Past Exam – May 2018, July 2021, May'23) (MTP April'22)

X Ltd. operates in coating industry. Its business segments comprise Coating (consisting of decorative, automotive, industrial paints and related activities) and Others (consisting of chemicals, polymers and related activities). Certain information for financial year 20X1-20X2 is given below: (₹ in lakhs)

Segments	External Revenue (including GST)	GST	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:

- Unallocated income net of expenses is ₹ 30,00,00,000
- Interest and bank charges is ₹ 20,00,00,000
- Income tax expenses is ₹ 20,00,00,000 (current tax ₹ 19,50,00,000 and deferred tax ₹ 50,00,000)
- Unallocated Investments are ₹ 1,00,00,00,000 and other assets are ₹ 1,00,00,00,000.
- Unallocated liabilities, Reserves & Surplus and Share capital are ₹ 2,00,00,00,000, ₹ 3,00,00,00,000 & ₹ 1,00,00,00,000 respectively.
- Depreciation amounts for coating & others are ₹ 10,00,00,000 and ₹ 3,00,00,000 respectively.
- Capital expenditure for coating and others are ₹ 50,00,00,000 and ₹ 20,00,00,000 respectively.
- Revenue from outside India is ₹ 6,20,00,00,000 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? (10 to 16 Marks)

Solution

i) 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 Revenue (gross)		2,00,000	70,000	2,70,000
GST		(5,000)	(3,000)	(8,000)
Total Revenue (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			(1,950)
	-Current taxes			
	-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			<u>10,000</u>
	Total Assets			<u>1,00,000</u>
(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			<u>1,00,000</u>
(c)	Others			
	Capital Expenditure	(5,000)	(2,000)	(7,000)
	Depreciation	(1,000)	(300)	(1,300)
Geographical Information				(₹ in lakhs)
		India (₹)	Outside India (₹)	Total (₹)
	Revenue	2,55,000	62,000	3,17,000
	Segment assets	90,000	10,000	1,00,000
	Capital expenditure	7,000		7,000

Notes:

- 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.
- 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.
- Corresponding figures for previous year have not been provided. However, in practical scenario the corresponding figures would need to be given.

Illustration 13 - (RTP – MAY 2019)

An entity uses the weighted average cost formula to assign costs to inventories and cost of goods sold for financial reporting purposes, but the reports provided to the chief operating decision maker use the First-In, First-Out (FIFO) method for evaluating the performance of segment operations. Which cost formula should be used for Ind AS 108 disclosure purposes?

Solution

The entity should use First-In, First-Out (FIFO) method for its Ind AS 108 disclosures, even though it uses the weighted average cost formula for measuring inventories for inclusion in its financial statements. Where chief operating decision maker uses only one measure of segment asset, same measure should be used to report segment information. Accordingly, in the given case, the method used in preparing the financial information for the chief operating decision maker should be used for reporting under Ind AS 108.

However, reconciliation between the segment results and results as per financial statements needs to be given by the entity in its segment report.

Illustration 14 - (RTP May'20) (Past Exam Nov'22)

ABC Limited has 5 operating segments namely A, B, C, D and E. The profit/ loss of respective segments for the year ended March 31, 20X1 are as follows:

Segment	Profit/(Loss) (₹ in crore)
A	780
B	1,500
C	(2,300)
D	(4,500)
E	6,000
Total	1,480

Based on the quantitative thresholds, which of the above segments A to E would be considered as reportable segments for the year ending March 31, 20X1? (5 Marks)

Solution

With regard to quantitative thresholds to determine reportable segment relevant in context of instant case, paragraph 13(b) of Ind AS 108 may be noted which provides as follows:

“The absolute amount of its reported profit or loss is 10 per cent 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.”

In compliance with Ind AS 108, the segment profit/loss of respective segment will be compared with the greater of the following:

- (i) All segments in profit, i.e., A, B and E – Total profit ₹ 8,280 crores.
- (ii) All segments in loss, i.e., C and D – Total loss ₹ 6,800 crores.

Greater of the above – ₹ 8,280 crores.

Based on the above, reportable segments will be determined as follows:

Segment	Profit/(Loss) (₹ in crore)	As absolute % of ₹ 8,280 crore	Reportable segment
A	780	9%	No
B	1,500	18%	Yes
C	(2,300)	28%	Yes
D	(4,500)	54%	Yes
E	6,000	72%	Yes
Total	1,480		

Hence B, C, D, E are reportable segments.

Question 1

Heavy Goods Ltd. has 6 operating segments namely L-Q (below). The total revenues (internal and external), profits or losses and assets are set out below: (In ₹)

Segment	Inter Segment Sales	External Sales	Profit / loss	Total assets
L	4,200	12,300	3,000	37,500
M	3,500	7,750	1,500	23,250
N	1,000	3,500	(1,500)	15,750
O	0	5,250	(750)	10,500
P	500	5,500	900	10,500
Q	<u>1,200</u>	<u>1,050</u>	<u>600</u>	<u>5,250</u>
	<u>10,400</u>	<u>35,350</u>	<u>3,750</u>	<u>1,02,750</u>

Heavy Goods Ltd. needs to determine how many reportable segments it has. You are required to advise Heavy Goods Ltd. as per the criteria defined in Ind AS 108. (4 Marks)

SOLUTION

As per paragraph 13 of Ind AS 108, an entity shall 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 inter-segment sales or transfers, is 10 per cent or more of the combined revenue, internal and external, of all operating segments.

Combined total sales of all the segment = ₹ 10,400 + ₹ 35,350 = ₹ 45,750.

10% thresholds = $45,750 \times 10\% = 4,575$.

- (b) The absolute amount of its reported profit or loss is 10 per cent 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.

In the given situation, combined reported profit = ₹ 6,000 and combined reported loss (₹ 2,250). Hence, for 10% thresholds ₹ 6,000 will be considered.

10% thresholds = ₹ 6,000 $\times$ 10% = ₹ 600

- (c) Its assets are 10 per cent or more of the combined assets of all operating segments. Combined total assets of all the segment = ₹ 1,02,750

10% thresholds = ₹ 1,02,750 $\times$ 10% = 10,275

Accordingly, quantitative thresholds are calculated below:

Segments	L	M	N	O	P	Q	Reportable segments
% segment sales to total sales	36.66%	24.59%	9.84%	11.48%	13.11%	4.92%	L, M, O, P
% segment profit to total profits	50%	25%	25%	12.5%	15%	10%	L, M, N, O, P, Q
% segment assets to total assets	36.50%	22.63%	15.33%	10.22%	10.22%	5.11%	L, M, N, O, P

Segments L, M, O and P clearly satisfy the revenue and assets tests and they are separate reportable segments.

Segment N does not satisfy the revenue test, but it does satisfy the asset test and it is a reportable segment.

Segment Q does not satisfy the revenue or the assets test but it does satisfy the profits test. Therefore, Segment Q is also a reportable segment.

Hence, all segments i.e; L, M, N, O, P and Q are reportable segments.

Question 2 (RTP May'22) (MTP May'23)

XYZ Ltd. has eight segments namely A, B, C, D, E, F, G and H. The information regarding respective segments for the year ended 31st March, 20X1 is as follows:

Segments	A	B	C	D	E	F	G	H
External sales	0	255	15	10	15	50	25	35
Inter-segment sales	100	60	30	5				
Total	100	315	45	15	15	50	25	35
Segment result Profit/(Loss)	5	(90)	15	(5)	8	(5)	5	7
Segment assets	15	47	5	11	3	5	5	9

Identify which of the above segments out of A to H would be considered as reportable segments of XYZ Ltd. for the year ending 31st March, 20X1? (5 Marks)

Solution:

An entity has eight segments and the relevant information is as follows:

Critical 1: Segment revenue is 10% or more of total external + intersegment sales

Segments	A	B	C	D	E	F	G	H	Total
Total sales	100	315	45	15	15	50	25	35	600
% to total sales	16.7	52.5	7.5	2.5	2.5	8.3	4.2	5.8	
Reportable segments	A	B	-	-	-	-	-	-	

Criteria 2: 10% or more of segment result

Consider segment profit and loss separately in absolute terms

Segments	A	B	C	D	E	F	G	H	Total
Profit	5	-	15	-	8	-	5	7	40
Segments loss	-	90	-	5	-	5	-	-	100

Since segment loss is greater, we select 100 as evaluating the segment percentage

Segments	A	B	C	D	E	F	G	H	Total
% to segment loss	5	90	15	5	8	5	5	7	
Reportable segments	-	B	C	-	-	-	-	-	

Criteria 3: 10% or more of segment assets

Segments	A	B	C	D	E	F	G	H	Total
Assets	15	47	5	11	3	5	5	9	100
%	15	47	5	11	3	5	5	9	100
Reportable segments	A	B	-	D	-	-	-	-	

Based on the above 3 criteria, the Reportable Segments are A, B, C & D

However, 75% test for external sales should also be checked.

Reportable Segments	A	B	C	D	TOTAL

External sales	0	255	15	10	280
Total entity's sales (external)					405
% of reportable segments external sales to entity's sales					69.14%
Required percentage					75%

Hence, in the above scenario, additional operating segments need to be identified as reportable segments, till the 75% test is satisfied, even if those segments do not satisfy the quantitative threshold limits.

Question 3 (Past Exam Nov'23)

Haymond Limited has three segments H, M & D. The following information is provided for the year ending 31st March, 2023: All amounts are in ₹ Lakhs

Particulars	Segments			Head Office
	H	M	D	
Sales to M	500	-	-	
Sales to D	-	5	-	
Other Sales (Domestic)	10	-	-	
Sales (Export)	680	170	40	
Operating Profit /(Loss) before tax	30	5	(8)	
Reallocated cost from Head Office	4	2	2	
Interest cost	2	3	1	
Fixed Assets*	20	4	12	5
Net Current Assets	12	4	9	3
Long Term Liabilities	2	1	12	2

Other Information:

- (i) Share Capital amounts to ₹ 40,00,000
- (ii) Reserve & Surplus amounts to ₹ 12,00,000

Prepare segment information as per Ind AS 108.

(8 Marks)

Solution:

(A) Information about operating segment

- 1) The company's operating segment comprise: H, M & D
- 2) Segment revenue, results and other information

Haymond Ltd.

Segment Information / Report

(All amounts are ₹ in lakhs)

Particulars	Reportable Segments			Head Office/ Unallocated items	Total
	H	M	D		
1. Segment Revenue					
Sales:					
Domestic	10	-	-	-	10
Export	680	170	40	-	890

External Sales	690	170	40		900
Inter-segment sales	<u>500</u>	<u>5</u>	<u>=</u>	<u>=</u>	<u>505</u>
Total Sales	1,190	175	40		1,405
Less: Inter-segment sales	<u>(500)</u>	<u>(5)</u>	<u>=</u>	<u>=</u>	<u>(505)</u>
Total Sales / Revenue	<u>690</u>	<u>170</u>	<u>40</u>		<u>900</u>
2. Results					
Segment result	30	5	(8)		27
Reallocated cost	<u>(4)</u>	<u>(2)</u>	<u>(2)</u>		<u>(8)</u>
Profit from operation before interest, taxation and Exceptional items	26	3	(10)		19
Finance cost (Interest expense)	<u>(2)</u>	<u>(3)</u>	<u>(1)</u>		<u>(6)</u>
Profit before tax and exceptional items	<u>24</u>	<u>0</u>	<u>(11)</u>		<u>13</u>
3. Information in relation to assets and liabilities					
Reportable segment non-current assets	20	4	12	5	41
Reportable segment net current assets	<u>12</u>	<u>4</u>	<u>9</u>	<u>3</u>	<u>28</u>
Total Assets	<u>32</u>	<u>8</u>	<u>21</u>	<u>8</u>	<u>69</u>
Non-current liabilities	2	1	12	2	17

B. Geographical Information

	₹ in lakhs		
Domestic	Sales	Export Sales	Total
External sales	10	890	900

IND AS 113 – FAIR VALUE MEASUREMENT

Illustration 1

Discount Rate assessment to measure present value:

Investment 1 is a contractual right to receive ₹ 800 in 1 year. There is an established market for comparable assets, and information about those assets, including price information, is available. Of those comparable assets:

- a) Investment 2 is a contractual right to receive ₹ 1,200 in 1 year and has a market price of ₹ 1,083.
- b) Investment 3 is a contractual right to receive ₹ 700 in 2 years and has a market price of ₹ 566.

All three assets are comparable with respect to risk (that is, dispersion of possible payoffs and credit).

You are required to measure the fair value of Asset 1 basis above information.

Solution

On the basis of the timing of the contractual payments to be received for Investment 1 relative to the timing for Investment 2 and Investment 3 (that is, one year for Investment 2 versus two years for Investment 3), Investment 2 is deemed more comparable to Investment 1. Using the contractual payment to be received for Investment 1 (₹ 800) and the 1-year market rate derived from Investment 2, the fair value of Investment 1 is calculated as under:

Investment 2 Fair Value	₹ 1,083
Contractual Cash flows in 1 year	₹ 1,200
IRR	= ₹ 1,083 × (1 + r) = ₹ 1,200
	= (1 + r) = (₹ 1,200 / ₹ 1,083) = 1.108
	r = 1.108 – 1 = 0.108 or 10.8%
Value of Investment 1	= ₹ 800 / 1.108 = ₹ 722

Alternatively, in the absence of available market information for Investment 2, the one-year market rate could be derived from Investment 3 using the build-up approach. In that case, the 2-year market rate indicated by Investment 3 would be adjusted to a 1-year market rate using the term structure of the risk-free yield curve. Additional information and analysis might be required to determine whether the risk premiums for one-year and two-year assets are the same. If it is determined that the risk premiums for one-year and two-year assets are not the same, the two-year market rate of return would be further adjusted for that effect.

Illustration 2

An asset is sold in 2 different active markets at different prices. An entity enters into transactions in both markets and can access the price in those markets for the asset at the measurement date.

In Market A:

The price that would be received is ₹26, transaction costs in that market are ₹3 and the costs to transport the asset to that market are ₹2.

In Market B:

The price that would be received is ₹25, transaction costs in that market are ₹1 and the costs to transport the asset to that market are ₹2.

You are required to calculate:

- (i) The fair value of the asset, if market A is the principal market, and
- (ii) The fair value of the asset, if none of the markets is principal market.

Solution

(i) If Market A is the principal market

If Market A is the principal market for the asset (i.e., the market with the greatest volume and level of activity for the asset), the fair value of the asset would be measured using the price that would be received in that market, after taking into account transport costs.

Fair Value will be

	₹
Price receivable	26
Less: Transportation cost	(2)
Fair value of the asset	<u>24</u>

(ii) If neither of the market is the principal market

If neither of the market is the principal market for the asset, the fair value of the asset would be measured using the price in the most advantageous market. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account transaction costs and transport costs (i.e., the net amount that would be received in the respective markets).

	₹	₹
	Market A	Market B
Price receivable	26	25
Less: Transaction cost	(3)	(1)
Less: Transportation cost	(2)	(2)
Fair value of the asset	<u>21</u>	<u>22</u>

Since the entity would maximise the net amount that would be received for the asset in Market B i.e. ₹22, the fair value of the asset would be measured using the price in Market B.

Fair value

	₹
Price receivable	25
Less: Transportation cost	(2)
Fair value of the asset	<u>23</u>

Illustration 3

Company J acquires land in a business combination. The land is currently developed for industrial use as a factory site. Although the land's current use is presumed to be its highest and best use unless market or other factors suggest a different use, Company J considers the fact that nearby sites have recently been developed for residential use as high-rise apartment buildings.

On the basis of that development and recent zoning and other changes to facilitate that development, Company J determines that the land currently used as a factory site could be developed as a residential

site (e.g., for high-rise apartment buildings) and that market participants would take into account the potential to develop the site for residential use when pricing the land.

Determine the highest and best use of the land.

Solution

The highest and best use of the land is determined by comparing the following:

- The value of the land as currently developed for industrial use (i.e., an assumption that the land would be used in combination with other assets, such as the factory, or with other assets and liabilities); and
- The value of the land as a vacant site for residential use, taking into account the costs of demolishing the factory and other costs necessary to convert the land to a vacant site. The value under this use would take into account risks and uncertainties about whether the entity would be able to convert the asset to the alternative use (i.e., an assumption that the land would be used by market participants on a stand-alone basis).

The highest and best use of the land would be determined on the basis of the higher of these values. In situations involving real estate appraisal, the determination of highest and best use might take into account factors relating to the factory operations (e.g., the factory's operating cash flows) and its assets and liabilities (e.g., the factory's working capital).

Illustration 4 – (Past Exam May'22)

ABC Ltd. acquired 5% equity shares of XYZ Ltd. for ₹ 10 crore in the year 20X1-X2. The company is in process of preparing the financial statements for the year 20X2-X3 and is assessing the fair value at subsequent measurement of the investment made in XYZ Ltd. Based on the observable input, the ABC Ltd. identified a similar nature of transaction in which PQR Ltd. acquired 20% equity shares in XYZ Ltd. for ₹ 60 crore. The price of such transaction was determined on the basis of Comparable Companies Method (CCM)- Enterprise Value (EV) / EBITDA which was 8. For the current year, the EBITDA of XYZ Ltd. is ₹ 40 crore. At the time of acquisition, the valuation was determined after considering 5% of liquidity discount and 5% of non-controlling stake discount. What will be the fair value of ABC Ltd.'s investment in XYZ Ltd. as on the balance sheet date?

(5 Marks)

Solution:

Determination of Enterprise Value of XYZ Ltd.

Particulars	₹ in crore
EBITDA as on the measurement date	40
EV/EBITDA multiple as on the date of valuation	8
Enterprise value of XYZ Ltd.	320

Determination of subsequent measurement of XYZ Ltd.

Particulars	₹ in crore
Enterprise Value of XYZ Ltd.	320
ABC Ltd.'s share based on percentage of holding (5% of 320)	16
Less: Liquidity discount & Non-controlling stake discount (5%+5%=10%)	(1.6)
Fair value of ABC Ltd.'s investment in XYZ Ltd.	14.4

Illustration 5 – (Past Exam Nov'22)

UK Ltd. is in the process of acquisition of shares of PT Ltd. as part of business reorganization plan. The projected free cash flow of PT Ltd. for the next 5 years are as follows:

(₹ in crore)

Particulars	Year 1	Year 2	Year 3	Year 4	Year 5
Cash flows	187.1	187.6	121.8	269	278.8
Terminal Value					3,965

The weightage average cost of capital of PT Ltd. is 11%. The total debt as on measurement date is ₹ 1,465 crore and the surplus cash & cash equivalent is ₹ 106.14 crore.

The total numbers of shares of PT Ltd. as on the measurement date is 8,52,84,223 shares. Determine value per share of PT Ltd. as per Income Approach. (5 Marks)

Solution:

Determination of equity value of PT Ltd.

(₹ in crore)

Particulars	Year 1	Year 2	Year 3	Year 4	Year 5
Cash flows	187.1	187.6	121.8	269	278.8
Terminal Value					3,965
Discount rate	0.9009	0.8116	0.7312	0.6587	0.5935
Free Cash Flow available to the firm	168.56	152.26	89.06	177.19	2,518.69
Total of all years					3,105.76
Less: Debt					(1,465)
Add: Cash & Cash equivalent					106.14
Equity Value of PT Ltd.					1,746.90
No. of Shares					85,284,223.0
Per Share Value					204.83

Illustration 6 (Past Exam Dec'21, MTP May'24)

You are a senior consultant of your firm and are in process of determining the valuation of KK Ltd. You have determined the valuation of the company by two approaches i.e. Market Approach and Income approach and selected the highest as the final value. However, based upon the discussion with your partner you have been requested to assign equal weights to both the approaches and determine a fair value of shares of KK Ltd. The details of the KK Ltd. are as follows

Particulars	₹ in crore
Valuation as per Market Approach	5268.2
Valuation as per Income Approach	3235.2
Debt obligation as on Measurement date	1465.9
Surplus cash & cash equivalent	106.14
Fair value of surplus assets and Liabilities	312.4
Number of shares of KK Ltd.	8,52,84,223 shares

Determine the Equity value of KK Ltd. as on the measurement date on the basis of above details (4 Marks)

Solution:

Equity Valuation of KK Ltd.

Particulars	Weights	(₹ in crore)
As per Market Approach	50	5268.2
As per Income Approach	50	3235.2
Enterprise Valuation based on weights $(5268.2 \times 50\%) + (3235.2 \times 50\%)$		4,251.7
Less: Debt obligation as on measurement date		(1465.9)
Add: Surplus cash & cash equivalent		106.14
Add: Fair value of surplus assets and liabilities		312.40
Enterprise value of KK Ltd.		3204.33
No. of shares		85,284,223
Value per share		375.72

Illustration 7 - (RTP - Nov 2019)

Comment on the following by quoting references from appropriate Ind AS.

- (i) DS Limited holds some vacant land for which the use is not yet determined. the land is situated in a prominent area of the city where lot of commercial complexes are coming up and there is no legal restriction to convert the land into a commercial land.
The company is not interested in developing the land to a commercial complex as it is not its business objective. Currently the land has been let out as a parking lot for the commercial complexes around. The Company has classified the above property as investment property. It has approached you, an expert in valuation, to obtain fair value of the land for the purpose of disclosure under Ind AS.
On what basis will the land be fair valued under Ind AS?
- (ii) DS Limited holds equity shares of a private company. In order to determine the fair value' of the shares, the company used discounted cash flow method as there were no similar shares available in the market.
Under which level of fair value hierarchy will the above inputs be classified?
What will be your answer if the quoted price of similar companies were available and can be used for fair valuation of the shares?

Solution

(i) As per Ind AS 113, a fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use.

The highest and best use of a non-financial asset takes into account the use of the asset that is physically possible, legally permissible and financially feasible, as follows:

- A use that is physically possible takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (eg the location or size of a property).
- A use that is legally permissible takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (eg the zoning regulations applicable to a property).
- A use that is financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.

Highest and best use is determined from the perspective of market participants, even if the entity intends a different use. However, an entity's current use of a non-financial asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximise the value of the asset.

To protect its competitive position, or for other reasons, an entity may intend not to use an acquired non-financial asset actively or it may intend not to use the asset according to its highest and best use. Nevertheless, the entity shall measure the fair value of a non-financial asset assuming its highest and best use by market participants.

In the given case, the highest best possible use of the land is to develop a commercial complex. Although developing a business complex is against the business objective of the entity, it does not affect the basis of fair valuation as Ind AS 113 does not consider an entity specific restriction for measuring the fair value.

Also, its current use as a parking lot is not the highest best use as the land has the potential of being used for building a commercial complex.

Therefore, the fair value of the land is the price that would be received when sold to a market participant who is interested in developing a commercial complex.

(ii) As per Ind AS 113, unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. The unobservable inputs shall reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk.

In the given case, DS Limited adopted discounted cash flow method, commonly used technique to value shares, to fair value the shares of the private company as there were no similar shares traded in the market. Hence, it falls under Level 3 of fair value hierarchy.

Level 2 inputs include the following:

- (a) quoted prices for similar assets or liabilities in active markets.
- (b) quoted prices for identical or similar assets or liabilities in markets that are not active.
- (c) inputs other than quoted prices that are observable for the asset or liability.

If an entity can access quoted price in active markets for identical assets or liabilities of similar companies which can be used for fair valuation of the shares without any adjustment, at the measurement date, then it will be considered as observable input and would be considered as Level 2 inputs.

Illustration 8 - (RTP – Dec 2021)

On 1st January, 20X1, A Ltd assumes a decommissioning liability in a business combination. The reporting entity is legally required to dismantle and remove an offshore oil platform at the end of its useful life, which is estimated to be 10 years. The following information is relevant:

If A Ltd was contractually allowed to transfer its decommissioning liability to a market participant, it concludes that a market participant would use all of the following inputs, probability weighted as appropriate, when estimating the price it would expect to receive:

a. Labour costs

Labour costs are developed based on current marketplace wages, adjusted for expectations of future wage increases, required to hire contractors to dismantle and remove offshore oil platforms. A Ltd. assigns probability to a range of cash flow estimates as follows:

Cash Flow Estimates:	100 Cr	125 Cr	175 Cr
Probability:	25%	50%	25%

b. Allocation of overhead costs:

Assigned at 80% of labour cost

c. The compensation that a market participant would require for undertaking the activity and for assuming the risk associated with the obligation to dismantle and remove the asset. Such compensation includes both of the following:

I. Profit on labour and overhead costs:

A profit mark-up of 20% is consistent with the rate that a market participant would require as compensation for undertaking the activity

II. The risk that the actual cash outflows might differ from those expected, excluding inflation:

A Ltd. estimates the amount of that premium to be 5% of the expected cash flows. The expected cash flows are 'real cash flows' / 'cash flows in terms of monetary value today'.

d. Effect of inflation on estimated costs and profits

A Ltd. assumes a rate of inflation of 4 percent over the 10-year period based on available market data.

e. Time value of money, represented by the risk-free rate: 5%

f. Non-performance risk relating to the risk that Entity A will not fulfill the obligation, including A Ltd.'s own credit risk: 3.5%

A Ltd. concludes that its assumptions would be used by market participants. In addition, A Ltd. does not adjust its fair value measurement for the existence of a restriction preventing it from transferring the liability.

You are required to calculate the fair value of the asset retirement obligation.

SOLUTION

		Amount (In Cr)
Expected Labour Cost (Refer W.N.)		131.25
Allocated Overheads	(80% x 131.25 Cr)	105.00
Profit markup on Cost	(131.25 + 105) x 20%	47.25
Total Expected Cash Flows before inflation		283.50
Inflation factor for next 10 years (4%)	$(1.04)^{10} = 1.4802$	
Expected cash flows adjusted for inflation	283.50×1.4802	419.65
Risk adjustment - uncertainty relating to cash flows	(5% x 419.64)	20.98
Total Expected Cash Flows	$(419.65 + 20.98)$	440.63
Discount rate to be considered = risk-free rate + entity's non-performance risk	5% + 3.5%	8.5%
Expected present value at 8.5% for 10 years	$(440.63 / (1.085)^{10})$	194.97

Working Note:**Expected labour cost:**

Cash Flows Estimates	Probability	Expected Cash Flows
100 Cr	25%	25 Cr
125 Cr	50%	62.50 Cr
175 Cr	25%	43.75 Cr
Total		131.25 Cr

Illustration 9 - (RTP Dec'21) (MTP May'23, Nov'23)

- i. Entity A owns 250 ordinary shares in company XYZ, an unquoted company. Company XYZ has a total share capital of 5,000 shares with nominal value of ₹ 10. Entity XYZ's after-tax maintainable profits are estimated at ₹ 70,000 per year. An appropriate price/earnings ratio determined from published industry data is 15 (before lack of marketability adjustment). Entity A's management estimates that the discount for the lack of marketability of company XYZ's shares and restrictions on their transfer is 20%. Entity A values its holding in company XYZ's shares based on earnings. Determine the fair value of Entity A's investment in XYZ's shares.
- ii. Based on the facts given in the aforementioned part (i), assume that, Entity A estimates the fair value of the shares it owns in company XYZ using a net asset valuation technique. The fair value of company XYZ's net assets including those recognised in its balance sheet and those that are not recognised is ₹ 8,50,000. Determine the fair value of Entity A's investment in XYZ's shares. **(5 Marks)**

Solution:

i) An earnings-based valuation of Entity A's holding of shares in company XYZ could be calculated as follows:

Particulars	Unit
Entity XYZ's after-tax maintainable profits (A)	₹ 70,000
Price/Earnings ratio (B)	15
Adjusted discount factor (C) (1- 0.20)	0.80
Value of Company XYZ (A) x (B) x (C)	₹ 8,40,000

Value of a share of XYZ = ₹ 8,40,000 ÷ 5,000 shares = ₹ 168

The fair value of Entity A's investment in XYZ's shares is estimated at ₹ 42,000 (that is, 250 shares × ₹ 168 per share).

(i) Share price = ₹ 8,50,000 ÷ 5,000 shares = ₹ 170 per share.

The fair value of Entity A's investment in XYZ shares is estimated to be ₹ 42,500 (250 shares × ₹ 170 per share).

Illustration 10

A Ltd. has invested in certain bonds. The fair value of these bonds in different markets to which A Ltd. has an access is as follows:

(i) Principal market	₹ 500
(ii) Highest and best use	₹ 600
(iii) Net present value of expected cash flows	₹ 550
(iv) Asset based valuation approach	₹ 450

What will be the fair value of bond as per Ind AS 113?

Solution:

As per para 24 of Ind AS 113, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (i.e. an exit price) regardless of whether that price is directly observable or estimated using another valuation technique.

Further, para 72 of the standard inter alia states that the fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (Level 3 inputs).

According to the above, the value of bond shall be ₹ 500 based on the principal market.

Question 1 - (PAST EXAM - Nov 2019)

An asset is sold in two different active markets at different prices. Manor Ltd. enters into transactions in both markets and can access the price in those markets for the asset at the measurement date.

In Mumbai market, the price that would be received is ₹ 290, transaction costs in that market are ₹ 40 and the costs to transport the asset to that market are ₹ 30. Thus, the net amount that would be received is ₹ 220.

In Kolkata market the price that would be received is ₹ 280, transaction costs in that market are ₹ 20 and the costs to transport the asset to that market are ₹ 30. Thus, the net amount that would be received in Kolkata market is ₹ 230.

- What should be the fair value of the asset if Mumbai Market is the principal market? What should be fair value if none of the markets is principle market?
- It the net realization after expenses is more in export market, say ₹ 280, but Government allows only 15% of the production to be exported out of India. Discuss what would be fair value in such case.

(8 Marks)**Solution:****i)****a) If Mumbai Market is the principal market**

If Mumbai Market is the principal market for the asset (i.e., the market with the greatest volume and level of activity for the asset), the fair value of the asset would be measured using the price that would be received in that market, after taking into account transportation costs.

Fair value will be

	₹
Price receivable	290
Less: Transportation cost	(30)
Fair value of the asset	<u>260</u>

b) If neither of the market is the principal market

If neither of the market is the principal market for the asset, the fair value of the asset would be measured using the price in the most advantageous market. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account transaction costs and transportation costs (i.e., the net amount that would be received in the respective markets).

	₹	₹
	Mumbai Market	Kolkata Market
Fair value of the asset as per the question	<u>220</u>	<u>230</u>

Since the entity would maximise the net amount that would be received for the asset in Kolkata Market i.e. ₹ 230, the fair value of the asset would be measured using the price in Kolkata Market.

Fair value in such a case would be

	₹
Price receivable	280
Less: Transportation cost	(30)
Fair value of the asset	<u>250</u>

- ii) Export prices are more than the prices in the principal market and it would give highest return comparing to the domestic market. Therefore, the export market would be considered as most advantageous market. But since the Government has capped the export, maximum upto 15% of total output, maximum sale activities are being done at domestic market only i.e. 85%. Since the highest level of activities with highest volume is being done at domestic market, principal market for asset would be domestic market. Therefore, the prices received in domestic market would be used for fair valuation of assets.