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Volume -2

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**Professional & Ethical Duty of a CA
and
Accounting & Technology**



CASE SCENARIO BASED MCQs



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IND AS 27 – SEPARATE FINANCIAL STATEMENTS

"Failure will Never Overtake Me

If My Determination to Succeed is Strong Enough"

1. DETAILED OVERVIEW OF THE STANDARD

The detailed summary of this standard is as follows:

1. This standard deals with **How to Account for Investments** in:
 - Subsidiary Co.,
 - Associate Co. and
 - Joint venture Co.
 in the **individual financial statements of Investor** (i.e. Parent Co.)
2. **Separate financial statements are presented in addition to** Consolidated Financial Statements (prepared in case of a subsidiary or subsidiaries, Associates and JV)
3. **Entity may present separate financial statements as its only financial statements if it is:**
 - i. Exempt from consolidation; or
 - ii. Exempt from applying equity method; or
 - iii. Entity is an investment entity (it is exempt from consolidation for all of its subsidiaries).
4. Investor (i.e. Parent Co.) shall account for its investments in Subsidiary, Associate and Joint Venture either at:
 - **Cost or**
 - **As per Ind AS 109 Financial Instruments i.e. Fair Value (FVTPL or FVTOCI)**
 (i.e. we have choice to value our investments in individual financial statements at **Cost or at Fair Value**)

Note:

1. However, the above choice is not available for Investment Entities, venture capital organization, or a mutual fund, unit trust and similar entities including investment-linked insurance funds.
2. Such entities shall apply FVTPL only on the Investments in Subsidiaries/Associates/JV
3. **Characteristics of Investment Entities are:**
 - It has more than one investment;
 - It has more than one investor;
 - It has investors that are not related parties of the entity;
 - It has ownership interests in the form of equity or similar interests.

5. **Apply Cost Model or Fair Value Model to the entire Category of Investments.** Category of investments" means broad category such as:

- Investments in subsidiary,
- Investments in associates and
- Investments in Joint ventures.

It is possible to apply a "cost" approach in respect of one category and "fair value" approach for another category. However, it is not possible to apply "cost" approach to one subsidiary and "fair value" approach to another subsidiary.

- Income from the Investments in Subsidiaries/Joint Ventures/ Associates shall be recognised in the P&L Statement of the Holding/Investor when right to receive such income is established. Generally, the right to receive the dividend is established when the dividend is approved by the shareholders in their general meeting.
- Investments classified under Cost Model are subject to Impairment testing as per Ind AS 36. No need for impairment testing under Ind AS 36 for FVTPL Model.

2. WHAT IF INVESTMENTS ARE HELD FOR SALE?

If Investments in Subsidiary, Associate or Joint Venture are Classified as "Held for Sale" as per Ind AS 105, apply following:

| If Investments are Measured at COST | If Investments are Measured at Fair Value |
|---|--|
| Re-measure such Investments as per Ind AS 105 i.e. Carrying Amount or FVLCTS whichever is lower | No need to re-measure the investments. Continue to apply Fair Value only |

Example 1

An entity has invested in a subsidiary and a joint venture. Entity has elected to measure investment in subsidiary at cost and measure investment in joint venture at fair value through profit or loss in accordance with Ind AS 109. Now, at the end of the year, both these investments are held for sale. In such case, the investment in subsidiary will be measured as per Ind AS 105 i.e. at lower of its carrying amount and fair value less costs to sell. However, investment in joint venture is continued to be accounted at fair value through profit or loss as per Ind AS 109.

3. WHEN A PARENT CEASES TO BE INVESTMENT ENTITY OR BECOME INVESTMENT ENTITY – Treatment in SFS

| When an Entity becomes an Investment Entity | When an Entity ceases to be an Investment Entity |
|---|---|
| Recognise the Investments at FVTPL as per Ind AS 109 Note: any difference between Carrying Amount of Investments and Fair Value of Investments is: Gain/Loss - Transfer to Profit&. Loss | Option I - Cost model Fair Value on the date of change of status is taken as deemed cost Option II - Continue as per Ind AS 109 |

Note: Any cumulative balance in OCI shall be reclassified to Profit & Loss on the date of disposal of investment.

Example 2: (When an Entity ceases to be an Investment Entity)

A Ltd. was an investment entity and was measuring its investment in subsidiary X Ltd. at fair value. On 1 April 20X1, A Ltd. ceased to be an investment entity. On that date, the fair value of investment in X Ltd. recorded in its books was ₹1,00,000. Now, when A Ltd. ceased to be an investment entity, it can measure the investment in X Ltd. either:

- At cost (in such case, the carrying value of { 1,00,000 will be its deemed cost at the date of change in status), or
- Continue to measure in accordance with Ind AS 109

Example 3 (When an Entity becomes an Investment Entity)

A Ltd. holds investment in a subsidiary X Ltd. and it measures its investment in subsidiary at cost. On 1 April 20X1, A Ltd. becomes an investment entity. On that date, the carrying value of investment in X Ltd. recorded in its books was ₹1,00,000. However, the fair value of that investment on the date of change in status was ₹1,50,000. Hence, A Ltd. should record a gain of ₹50,000 (1,50,000 - 1,00,000) in the Profit and Loss Account. In this case, assume that A Ltd. was measuring the above investment at fair value through other comprehensive income in accordance with Ind AS 109 prior to change in status. The cumulative gain recorded in other comprehensive income was ₹50,000 and the carrying value of investment was ₹1,50,000. Hence, on the date of change in status, A Ltd. shall reclassify the gain of ₹50,000 from other comprehensive income to profit or loss as if the investment has been disposed by A Ltd. on that date.

4. REORGANIZATION OF THE GROUP STRUCTURE

- 1) A parent re-organize the structure of its group by establishing a new entity as its parent
- 2) Ind AS 27 provides guidance on how to calculate the cost of investment when a parent reorganizes the structure of its group by establishing a new entity as its parent.
- 3) Cost of Investment for New Parent Company will be the Carrying Amount of Equity Items of Old Parent Company, subject to below conditions:
 - a) New Parent Company must issue its equity shares as consideration for acquiring shares of old parent company.
 - b) There must be No change in Net worth of whole group.
 - c) Owner's Position in New Group must be same as Position existed in Old Group.
- 4) If above conditions are not fulfilled, then Cost of Investment for New Parent will be Actual Fair Value on the date of Investment.

(Refer Q2 of Question Bank)

5. MAJOR CHANGES IN INDAS 27 FROM IAS 27

| Ind AS 27 | IAS 27 (IFRS) |
|--|---|
| It allows Investors to apply either: Cost Model; or Fair Value Model | It allows Investors to apply either: Cost Model; or Fair Value Model; or Equity Method |

Student Notes:-



IND AS 103 – BUSINESS COMBINATION

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IND AS 110 – CONSOLIDATION

(PRACTICAL PORTION)

1. WHAT IS BUSINESS COMBINATION (Ind AS 103)

- 1) A business combination is a transaction in which the **acquirer obtains control of another business** (the acquiree).
- 2) Business in a simple language means **Net Assets and Decision-Making Process**.
- 3) Control over the business can be acquired in following ways:

| Types of Acquisitions | How to Deal |
|--|---|
| Acquisition of Net Assets of another Company physically | <ul style="list-style-type: none"> • In this case, the acquiring company (Selling Co.) is liquidated. • Here, Ind AS 103 will be applicable only in the Separate Financial Statements of Acquirer (Purchaser Company). • In this case Acquirer will account for business combination in its SFS only as per IND AS 103 [no need to prepare CFS separately] |
| Acquisition of More than 50% Equity Shares of another Company (i.e. making Subsidiary company) | <ul style="list-style-type: none"> • Here subsidiary company is not liquidated. • In this case, acquirer company shall apply following Ind AS: <ol style="list-style-type: none"> a) Ind AS 27 in SFS of Acquirer b) Ind AS 103 for Recording Business Acquisition Transaction First Time in Consolidated Financial Statements (CFS). c) Ind AS 110 for Preparing CFS on every Balance Sheet Date. |

2. HOW TO RECORD THE BUSINESS ACQUISITION TRANSACTION

(Ind AS 103)

There are two methods to record transactions of Business Acquisitions:

| Method 1 | Method 2 |
|---|--|
| <p><u>Acquisition Method:</u> Applicable for All Types of Business Acquisitions other than Common Control Business Combination (CCBC).</p> <p>Acquisition Method means Fair Value Accounting of Net Assets Acquired</p> | <p><u>Pooling of Interest Method:</u> Applicable only in the case of Common Control Business Combination (CCBC).</p> <p>Pooling of Interest means recording the Net Assets acquired at Book Value.</p> |

3. ACQUISITION METHOD (Ind AS 103)

Following Steps shall be applied for Acquisition Method:

| | |
|---|---|
| <p>Step 1: Identify the Acquirer Company</p> | <p>Entity (or individual) who obtains the Control over business of another entity and Pays the Consideration.</p> <p><u>Exception:</u> Under Reverse Acquisition acquirer doesn't pay the consideration (will be discussed later)</p> <p>Control is defined under Ind AS 110.</p> |
| <p>Step 2: Determining the Acquisition date (DOA) (Refer Example 1 below)</p> | <p>The date on which acquirer obtained the Control over Business of Acquiree.</p> <p>It is generally the date on which the acquirer discharges the consideration and acquires the Net Assets. (also called agreement date)</p> <p>If any approval of regulating authority is required for business combination, then the date of obtaining approval may be considered as DOA.</p> <p><u>Non-binding letter of intent</u> signed by entities where consideration and other conditions are expected to complete in future - Do not treat it as Acquisition of Control unless conditions complied.</p> |

On DOA, Acquirer must Apply Ind AS 103 for the first time and has to measure following items:

- 1) Purchase Consideration (Agreed between Acquirer and Acquiree)
- 2) Fair Value of Net Assets Acquired,
- 3) Value of Non-controlling Interest if any and
- 4) Value of Goodwill or Gain from Bargain Purchase.

| | | | | | | | | | |
|---|---|--------------------------------------|------|---------|-----|---------------------------------|--------|-------------------------|------------|
| <p>Step 3: Calculate Purchase Consideration (PC) on DOA</p> | <p>PC consist of anything paid or discharged to the Shareholders of Acquiree co.</p> <p>If PC is discharged to acquire more than 50% shares, then such PC shall be presented in the name of Investment A/c in SFS of Acquirer co.</p> <p>PC consist of:</p> <ul style="list-style-type: none"> • Payment in Cash immediately, • Payment in cash in future (deferred consideration) at PV • Issue of shares or debentures, • Payment of contingent consideration, • Issue of share-based payment awards to the employees of Acquiree etc. <p>(See main point no. 4 below in detail)</p> | | | | | | | | |
| <p>Step 4: Calculate Fair Value of Net Assets taken over as on DOA</p> | <p>Net Assets means: Assets Taken Over at Fair Value (-) Liabilities taken over at Fair Value or Payable Value</p> <p>(See main point no. 6 below in detail)</p> | | | | | | | | |
| <p>Step 5: Calculate Non-controlling Interest in Subsidiary (if any) (aka NCI)</p> | <p>NCI means outside shareholders of Acquiree company. Shares held by outside shareholders are considered here.</p> <p>NCI can be calculated in two ways:</p> <ol style="list-style-type: none"> a) Fair Value Method b) Proportion of Net Assets Method <p>NCI shall be zero if acquirer has acquired 100% shares of subsidiary.</p> <p>(See main point no. 7 below in detail)</p> | | | | | | | | |
| <p>Step 6: Calculation of Goodwill (or) Gain from Bargain Purchase (Capital reserve)</p> | <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%;">Purchase Consideration (to Acquiree)</td> <td style="width: 40%; text-align: right;">XXXX</td> </tr> <tr> <td>(+) NCI</td> <td style="text-align: right;">XXX</td> </tr> <tr> <td>(-) 100% Net Assets of Acquiree</td> <td style="text-align: right;">(XXXX)</td> </tr> <tr> <td>Goodwill (or) CR</td> <td style="text-align: right;">XXX</td> </tr> </table> | Purchase Consideration (to Acquiree) | XXXX | (+) NCI | XXX | (-) 100% Net Assets of Acquiree | (XXXX) | Goodwill (or) CR | XXX |
| Purchase Consideration (to Acquiree) | XXXX | | | | | | | | |
| (+) NCI | XXX | | | | | | | | |
| (-) 100% Net Assets of Acquiree | (XXXX) | | | | | | | | |
| Goodwill (or) CR | XXX | | | | | | | | |

| | |
|--|---|
| | <i>(See main point no. 8 below in detail)</i> |
| Journal Entry on DOA (in the books of Acquirer) | <p>Assets Taken over A/c Dr. (Fair Value)</p> <p>Goodwill A/c Dr. (bal. fig.)</p> <p> To Liabilities taken over A/c (Fair Value)</p> <p> To NCI A/c (Step 5)</p> <p> To Investment* (PC) A/c (Step 3)</p> <p> To Deferred Consideration A/c</p> <p> To Contingent Consideration A/c</p> <p> To SBP Reserve A/c (Pre Combination Period Exp)</p> <p> To Capital Reserve A/c (GBP)</p> <p>If investment a/c is already debited in SFS of Acquirer, then Investment a/c will be credited here otherwise Cash A/c or Equity Share Capital A/c</p> |

Note:

Once Ind AS 103 is applied as above, if there is a need to prepare Consolidated Financial Statements then Ind AS 110 shall be applied.

Example 1: (Date of Acquisition)

Company A acquired 80% equity interest in Company B for cash consideration. The relevant dates are as under:

| | |
|---|------------------|
| ✓ Date of shareholder agreement | 1st April, 20X1 |
| ✓ Appointed date as per shareholder agreement | 1st June, 20X1 |
| ✓ Date of obtaining control over the board representation | 1st July, 20X1 |
| ✓ Date of payment of consideration | 15th July, 20X1 |
| ✓ Date of transfer of shares to Company A | 1st August, 20X1 |

In this case, as the control over financial and operating policies are acquired through obtaining board representation on 1st July, 20X1, it is this date that is considered as the acquisition date. It may be noted that the appointed date as per the agreement is not considered as the acquisition date, as the Company A did not have control over Company B as at that date.

Note: In case date of obtaining control is not given then date of payment is considered as DOA.

4. PURCHASE CONSIDERATION (Ind AS 103)

Purchase Consideration shall be calculated as under:

| | |
|---|-----|
| Cash Paid Immediately | XXX |
| (+) Deferred Cash at Present Value (to be paid in future) | XXX |
| (+) Fair Value of Equity Shares issued | XXX |
| (+) Fair Value of other securities issued | XXX |
| (+) Fair Value of Contingent Consideration | XXX |
| (+) Fair Value of Share Based Awards (ESOPs) granted to Acquirees' employees as replacement awards (Pre- Combination Period) | XXX |
| (+/-) Adjustment due to Pre-existing relationships between Acquirer & Acquiree | XXX |
| (Refer Example 2) | |

To Calculate PC, following key points are important:

| | | | | | | | | | |
|---|---|-----------------------------|-----------------|-------------|--------------|----------------------|----------------|---------------------------------------|------|
| Acquisition Related Cost | <ul style="list-style-type: none"> Cost incurred by acquirer in relation to business acquisition (also known as Transaction Cost) but paid to other party (not acquiree) is not a part of PC. It shall be directly charged to Profit and Loss A/c of Acquirer. E.g. Stamp Duty, Legal Expenses, any payment to regulator of acquiree to run license. | | | | | | | | |
| Deferred Consideration (Refer Q1406 of Question Bank) | <ul style="list-style-type: none"> Cash which is committed to be paid in future is called deferred consideration. The present value of deferred cash shall be added to PC and credit shall be "Deferred Consideration Payable (liability) A/c" Journal Entry: <table style="width: 100%; border: none;"> <tr> <td style="width: 60%;">Net Assets Acquired A/c Dr.</td> <td style="text-align: right;">(at Fair Value)</td> </tr> <tr> <td style="padding-left: 20px;">To Cash A/c</td> <td style="text-align: right;">(PC in Cash)</td> </tr> <tr> <td style="padding-left: 20px;">To Equity Shares A/c</td> <td style="text-align: right;">(PC in Shares)</td> </tr> <tr> <td style="padding-left: 20px;">To Deferred Consideration Payable A/c</td> <td style="text-align: right;">(PC)</td> </tr> </table> Interest on above liability shall be calculated every year and charged to P&L of acquirer. | Net Assets Acquired A/c Dr. | (at Fair Value) | To Cash A/c | (PC in Cash) | To Equity Shares A/c | (PC in Shares) | To Deferred Consideration Payable A/c | (PC) |
| Net Assets Acquired A/c Dr. | (at Fair Value) | | | | | | | | |
| To Cash A/c | (PC in Cash) | | | | | | | | |
| To Equity Shares A/c | (PC in Shares) | | | | | | | | |
| To Deferred Consideration Payable A/c | (PC) | | | | | | | | |
| Contingent Consideration | <ul style="list-style-type: none"> Any payment which is committed to be discharged on fulfilment of specified conditions in future such as obtaining specified % of NP after 2 years or specified turnover. Fair Value of Contingent Consideration as on DOA is added to PC and credit shall be "Contingent Consideration Payable A/c" as liability. Journal Entry: <table style="width: 100%; border: none;"> <tr> <td style="width: 60%;">Net Assets Acquired A/c Dr.</td> <td style="text-align: right;">(at Fair Value)</td> </tr> <tr> <td style="padding-left: 20px;">To Cash A/c</td> <td style="text-align: right;">(PC in Cash)</td> </tr> </table> | Net Assets Acquired A/c Dr. | (at Fair Value) | To Cash A/c | (PC in Cash) | | | | |
| Net Assets Acquired A/c Dr. | (at Fair Value) | | | | | | | | |
| To Cash A/c | (PC in Cash) | | | | | | | | |

| | |
|---|--|
| | <p>To Equity Shares A/c (PC in Shares) To Contingent Consideration A/c (PC)</p> <ul style="list-style-type: none"> Any change in Fair Value is transferred to Profit and Loss a/c at year end. At the time of Actual payment if there is any difference arise between amount paid and recognised liability then such difference is charged to P&L A/c If specified conditions are not fulfilled, then the liability shall be reversed through Profit and Loss A/c. If contingent consideration is payable for Employment service i.e. for being in employment after DOA then such amount shall not become part of PC and treated as Post Acquisition Expense of Acquirer (P&L). |
| <p>ESOP of Acquiree replaced by Acquirer (Refer Q1406 of Question Bank)</p> | <ul style="list-style-type: none"> Acquirer at the time of acquisition may replace the ESOP granted by Acquiree for its employees with New ESOP of acquirer. Such new ESOPs of acquirer are known as Replacement Awards and Acquirer shall issue Equity Shares to the Employee of Acquiree in Future. Fair Value of Replacement Awards are divided into two parts: <ul style="list-style-type: none"> Pre-combination Period Expenses Post-combination Period Expenses Pre-combination period expenses shall become part of PC and calculated as under: $\frac{\text{Fair Value of Original Awards} \times \text{Vesting Period (VP) Expired}}{\text{Higher of Original VP or New VP of Replacement Awards}}$ Journal Entry: <p>Net Assets Acquired A/c Dr. (at Fair Value) To Cash A/c (PC in Cash) To Equity Shares A/c (PC in Shares) To SBP Reserves A/c (PC - Pre-Combination Period)</p> |
| <p>Adjustment of Pre-existing relationship between acquirer and acquiree</p> | <ul style="list-style-type: none"> Any Settlement (also called compensation) amount payable or receivable by acquirer to/from acquiree shall be calculated first. Such settlement amount may be included in PC The effect of settlement amount shall be eliminated from PC <p>(Read the Main Point no. 5 for more detail)</p> |

Example 2: (Purchase Consideration)

B Ltd. has 1,00,000 no. of equity shares outstanding

A Ltd. acquired 72,000 equity shares of B Ltd. (FV per share of B Ltd. is 36/-)

Consideration would be discharged in the form of cash of Rs. 5,00,000 immediately & one Equity Share of A Ltd. for Every two shares acquired (FV per share of A= 60/-)

In addition to above, A Ltd. will pay 6,00,000/- in cash after 1 year (Cost of Capital is 10%) Calculate Purchase Consideration as on Date of Acquisition

Solution:**Calculation of Purchase Consideration**

| Consideration in form of | Amount |
|---|------------------|
| 1) Equity shares of A Ltd (72,000/2 x 1) x 60/- | 21,60,000 |
| 2) Cash Immediate | 5,00,000 |
| 3) Deferred Cash at PV 6,00,000/1.1 | 5,45,455 |
| Purchase Consideration | 32,05,455 |

| SFS of A Ltd: (Journal Entry for A Ltd) | | |
|--|-----|-----------|
| DOA= Investment in B Ltd | Dr. | 32,05,455 |
| To Bank A/c | | 5,00,000 |
| To ESC and SP A/c | | 21,60,000 |
| To Def. Cash Payable A/c | | 5,45,455 |

After 1 Year: (5,45,455 X 10%) = 54,545/-

| | | | | |
|----|--------------------------|-----|----------|----------|
| a) | Interest Cost A/c (P&L) | Dr. | 54,545 | |
| | To Def. Cash Payable A/c | | | 54,545 |
| b) | Def. Cash Payable A/c | Dr. | 6,00,000 | |
| | To Bank A/c | | | 6,00,000 |

5. PRE-EXISTING RELATIONSHIP BETWEEN ACQUIRER AND ACQUIREE (Ind AS 103)

There can be two types of relationships:

1) Non-contractual Relationship:

- i) **Example** - Law Suit filed by acquirer on acquiree or vice versa
- ii) Acquirer and Acquiree agreed to **settle this law suit** due to business combination by paying/receiving compensation.
- iii) Above **compensation shall not become part of Purchase Consideration**. It is to be recognized separately as under in the books of Acquirer:

| Compensation Receivable | Compensation Payable |
|---------------------------------|-----------------------------|
| Compensation Receivable A/c Dr. | Loss (P&L) A/c Dr. |
| To Gain (P&L) A/c | To Compensation Payable A/c |

(Refer Example 3 below)

(Refer Example 4 below)

- iv) If any receivable/payable is shown in Books of Acquiree then it shall not become part of Net Assets to be acquired and recorded on DOA.

2) Contractual Relationships: (Refer Example 5 below)

- i. **Example** - Required Rights (i.e. Franchise rights given by Acquirer to Acquiree prior to date of acquisition)
- ii. On date of Acquisition, acquirer shall recognise:
 - a) "Required Rights" as a **Separate Identifiable Intangible Asset** apart from other Net Assets Acquired at Fair Value.
 - b) "Loss on Cancellation of Rights" at Lower of: -
 - **Penalty Payable as per Contractual Terms; or**
 - **Difference between Fair Value of Franchise & Proportionate Value of Contract.**
- iii. This loss on cancellation is deducted from PC and Recognised as Separate Liability as under:

Loss on Cancellation (P&L) A/c Dr.
To Penalty Payable A/c

Example 3: (Pre-Existing Relations)

Aakash Ltd. is Sued by Subhash Ltd. for a legal claim of Rs. 10 Lacs for a use of Trademark of Subhash Ltd. Aakash Ltd. has made provision for penalty payable of Rs. 6 Lacs. However Subhash Ltd. has not recognized any receivable for penalty.

After 1 year (Case is not yet settled), Subhash Ltd. acquired control over Aakash for a Consideration of Rs. 62 Lacs (net of above penalty claim).

Fair Value of Claim on Date of Acquisition is Rs. 10 Lacs

Fair Value of Net Assets Acquired of Aakash Ltd. is Rs. 70 Lacs.

Assume NCI is Nil. Calculate Goodwill or Gain from Bargain Purchase.

Golden Rule: PC should be kept separate from Pre-existing Relationships (PER). PC Should not include the effect of pre-existing Relationship. PER should be recog. separately at Fair Value on DOA.

Gross PC for Acquiring Control = 62 + 10 = 72

Journal Entries in the Books of subhash Ltd.

| | | |
|--|---------|----------|
| 1) Compensation Receivable Dr. To Gain (P&I) | 10 | 10 |
| 2) Net Asset Dr. Goodwill Dr. To Consideration Payable A/c | 70 2 | 72 |
| 3) Consideration payable A/c To Compensation Receivable A/c To Bank / Cash | 72 | 10 62 |

Example 4: (Pre-Existing Relations)

Consider above Example 3 with following changes:

- i) Now Subhash Ltd. is being sued by Aakash Ltd.
- ii) Gross Final Consideration Payable by Subhash Ltd. towards acquisition of business is Rs. 85 Lacs
- iii) Both Companies have not passed any entry of Payable or receivable of penalty in their books.

Solution

Actual Consideration to world acquiring Control = 85 - 10 = 75 Lacs.

| | | |
|---|----------|----|
| 1) Loss (P&I) A/c Dr. To Compensation Payable A/c | 10 | 10 |
| 2) Net Assets A/c Dr. Goodwill Dr. (b/f) To Consideration Payable A/c | 70 5 | 75 |
| 3) Consideration Payable A/c Dr. Compensation Payable A/c Dr. To Bank A/c | 75 10 | 85 |

Example 5: (Pre-Existing Relations)

V'Smart Academy Pune provided franchise rights for 10 years to Kolkata based Coaching Center for Rs. 10 Lacs. Penalty clause as per the contract due to cancellation of Franchise is 110% of remaining period of proportionate franchise fees.

After two years, Vsmart acquired Kolkata center at a consideration of Rs. 60 Lacs (Including Penalty). Fair Value of Net Assets of Kolkata is Rs. 40 Lacs (other than Franchise Rights).

Fair Value of Franchise Rights as on DOA is Rs. 15 Lacs.

Solution:

- 1) Proportionate Value of Contract = $10/10 \times 8 = 8$ Lacs.
- 2) Penalty as per Contract = 8 Lacs + 10% = 8.8 Lacs.
- 3) Fair Value of Reacquired Rights = 15 Lacs.
- 4) Differences Between FV & Prop. Value of Contract = 7 Lacs. (15 - 8)
- 5) Lower will 7 Lacs. Payable which is recognised as penalty
- 6) PC for control acquisition = 60 - 7 = 53 Lacs.

DOA (Journal entry)

| | | |
|--|----------|---------|
| 1) Loss as Cancellation (P&I) A/c Dr. To Penalty Payable A/c | 7 | 7 |
| 2) Net Assets a/c Dr. Re-Acquired Rights a/c Dr. To Consideration Payable A/c To GBP (OCI - CR) A/c | 40 15 | 53 2 |
| 3) Penalty Payable Dr. Consideration Payable Dr. To Bank a/c | 7 53 | 60 |

6. NET ASSETS OF ACQUIREE (Ind AS 103)

- Identify the Net Assets of Acquiree company taken over by Acquirer company.
- All Assets and Liabilities taken over are **measured at Fair Value** as on Date of Acquisition (DOA).
- Identifiable Net Assets can be calculated as under:

Approach 1: Assets less Liabilities

| | |
|--|--------------------------|
| All Assets as per B/s of Acquiree which fulfills the recognition criteria for Acquirer (except Non-current assets HFS) | At Fair Value |
| (+) Assets which are not shown in B/s of Acquiree but fulfills recognition criteria for Acquirer | At Fair Value |
| (+) Non-Current Assets Held for Sale (HFS) | At Lower or CA or FVLCTS |
| (-) All Liabilities as per B/s of Acquiree which fulfills the recognition criteria for Acquirer | At Fair Value |
| (-) Contingent Liability of Acquiree accepted by Acquirer | At Fair Value |
| (-) DBO liability | as per Ind AS 19 |
| (+) Indemnification Asset Promised by Acquiree to Acquirer on above liabilities | At Fair Value |
| (+) Reacquired Rights (as per Pre-existing relationships) | At Fair Value |
| (+) In process Research Project of Acquiree | At Fair Value |
| (+/-) DTA/DTL arising due to Net Assets taken over at Fair Value (Fair Value is different from Tax Base) including DTA/DTL already appeared in B/s of Acquiree | As per Ind AS 12 |

Approach 2: Equity + Other Equity

| | |
|--|--|
| Equity Share Capital of Subsidiary Co. (Acquiree Co.) | |
| (+/-) Balance of Reserves (Other Equity) of Subsidiary Co. as on DOA | |
| (+/-) Assets liabilities not shown in Acquiree's Books but recognised by Acquirer | |
| (+/-) Fair Value Adjustments (Revaluations of Net Assets) as on DOA (discussed in detail in the next page) | |
| (-) Contingent Liabilities of Acquiree taken over | |

| | | |
|-------|---|--|
| (+) | Indemnification Asset Promised by Acquiree to Acquirer on above liabilities | |
| (+) | Reacquired Rights (as per Pre-existing relationships) | |
| (+) | In process Research Project of Acquiree at Fair Value | |
| (+/-) | DTA/DTL arising due to Net Assets taken over at Fair Value as on DOA | |

- **Contingent Liabilities of Acquiree:** Contingent Liabilities of acquiree shall be recognised by Acquirer only when such liability is created **due to present obligation** even though the outflow of economic benefits is not probable to occur. (Ignore Contingent liabilities arising due to possible obligation)
- **Indemnification assets** - The acquiree in a business combination may contractually indemnify the acquirer **for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability**. The acquirer shall recognize an indemnification asset at the same time that it recognizes the indemnified item measured on the same basis, subject to the certainty of collection. (**Record Indemnification Asset only if related Liability is also Recorded**)
- **Share based payments (ESOPs or Cash Liability)** - Principles of INDAS 102 shall be applicable to recognise Share based payment related reserves and liabilities.

(Refer 700 Series of FR Question Bank)

Example 6: (FV of Net Asset)**Balance Sheet of Acquiree as on 31/3/23**

| Particular | Amt |
|----------------------|--------------------|
| PPE | 80,00,000 |
| Current Asset | 30,00,000 |
| | 1,10,00,000 |
| Equity share capital | 40,00,000 |
| Other Equity | 35,00,000 |
| Liability | 35,00,000 |
| | 1,10,00,000 |

- Date of Acquisition is 31/3/23. Tax Rate is 30%
- FV of PPE on DOA is 90 lakhs, CA in CFS

Calculate FV of Net Assets

Solution:**Approach 1-**

| Particular | Amt |
|---------------------------------|------------------|
| PPE | 90,00,000 |
| (+) Current Asset | 30,00,000 |
| (-) Liabilities | (35,00,000) |
| (-) DTL on Business Combination | 3,00,000 |
| FV of Net Assets | 82,00,000 |

Approach 2-**Statement of Net Assets/Equity: -**

| Particular | Amt |
|------------------------------------|------------------|
| Equity Share Capital | 40,00,000 |
| Other Equity | 35,00,000 |
| + Revaluation Gain | 10,00,000 |
| (-) Revaluation Surplus due to DTL | (3,00,000) |
| FV of Net Assets | 82,00,000 |

7. NON-CONTROLLING INTEREST (Ind AS 103)

- a) **Meaning** - The Equity in a Subsidiary not acquired directly or indirectly by the Parent company. (i.e. when parent owns less than 100% of the equity of acquiree)
- b) **Presentation of NCI** - Separately in the Equity head of Balance sheet under Consolidated Financial Statements.
- c) **Measurement of NCI** - NCI is measured as per the following methods:
- (i) Fair Value Method
 - (ii) Proportionate Share of Net Assets Method

Method 1 - Fair value of shares held by NCI

Fair value will be either given in the question or it needs to be calculated as under:

Option 1: Fair Value Per Share of Acquiree (Subsidiary) \times No. of Shares held by NCI

Option 2:

Purchase Consideration discharged by Acquirer (Investments made by Acquirer) \times $\frac{\text{NCI \%}}{\text{\% held by Acquirer}}$

Note: Always apply "Option 2" only when Fair Value per share of Acquiree is not given.

Example: A Ltd. acquired 60% Shares of B Ltd. Total outstanding shares of B Ltd. are 5,00,000 no. Market Price per share of B Ltd. is 250/- per share.

$$\text{NCI} = 5,00,000 \times 40\% \times 250/- = \text{Rs. 5 Crores}$$

Example: A Limited acquires 80% shares of B Limited whose Net Assets fair value is Rs 140.00 crores by payment in cash of Rs. 120.00 crores. The value of non-controlling interest is Rs 30 crores.

$$\text{NCI} = 120/80\% \times 20\% = 30 \text{ Crores}$$

Method 2 - "Proportionate Share in Net Assets" method

How to Calculate: Fair Value of Net Assets of Acquiree as on DOA \times NCI %

Continuing with the above example in method 1 -

Assume that the value of recognized amount of subsidiary Rs. identifiable net assets is Rs 140.00 crores, as determined in accordance with Ind AS 103. The value of non-controlling interest is Rs 28.00 crores (i.e. Rs 140 crores \times 20%).

Note: Always apply Fair Value Method if MP of Share of Acquiree is given in the question.

d) Types of NCI -

| <u>Meaning</u> | <u>Qualifying NCI</u> | <u>Non-Qualifying NCI</u> |
|---------------------------|--|--|
| | Present ownership interest and entitles its holders to a proportionate share in the Net Assets | All other components of NCI |
| <u>Examples</u> | Ordinary Equity Shares Preference Shares entitled to a <i>pro-rata</i> share of net asset upon liquidation | Equity component of convertible debt and other compound financial instruments Share warrants Options under Share based payments |
| <u>Measurement of NCI</u> | Option 1 - At the Fair Value of the NCI Option 2 - Proportionate share of Net Assets acquired | At Fair Value only unless another measurement basis is required by Ind-AS. Eg. SBP options of NCI are measured as per Ind AS 102 |

e) Negative NCI - NCI can be negative also when Net Assets acquired are negative (i.e. Assets are less and Liabilities are more)

(Refer Practical Example No. 1 for more clarity) (Also Refer 500 Series of Question Bank)

8. CALCULATION OF GOODWILL OR GAIN ON BARGAIN PURCHASE

(Ind AS 103)

Goodwill or Gain from Bargain Purchase shall be calculated as under:

| | |
|---|-------------|
| Cost of Investments (Purchase Consideration Discharged) | XXXX |
| Add: Fair Value of Previous Equity Interest as on DOA held by Acquirer (in case of step Acquisition) | XXXX |
| Add: Non-Controlling Interest as per above two methods | XXXX |
| Less: 100% Net Assets of acquiree at Fair Value as on DOA | XXXX |
| Goodwill or Gain from Bargain Purchase (Capital Reserve) | XXXX |

Gain on Bargain Purchase - Ind AS 103 requires that the bargain purchase gain should be recognised in OCI and accumulated in equity as capital reserve.

If there is no clear evidence for the underlying reason for classification of the business combination as a bargain purchase, then it should be recognised directly in equity as capital reserve.

Goodwill -

- (i) Goodwill shall be presented in the Consolidated Balance Sheet separately from Other Intangible Assets.

- (ii) If goodwill is calculated by using the **Fair Value method of NCI** then such goodwill is called **Full Goodwill**.
- (iii) If goodwill is calculated by using **Proportionate share of Net Assets method of NCI**, then such goodwill is called **Partial Goodwill**.
- (iv) Goodwill is not allowed to be amortised but subject to annual impairment testing as per Ind AS 36

Carve Out - IFRS 3 requires entity to recognise Gain on Bargain Purchase directly to Statement of Profit and Loss.

(Refer Practical Example No. 1 for more clarity) (Also Refer 500 Series of Question Bank)

MEASUREMENT PERIOD -

- (i) If all the required information to calculate Net Assets is **not available on date of acquisition (DOA)** then Goodwill or Gain from bargain purchase can be **calculated on provisional basis** until the complete information is received.
- (ii) When **new information is received (within 1 year)** regarding fair value of Asset and Liabilities as on DOA and **such information reflects the facts and circumstances existing on DOA**, then it is allowed to make the **required changes in the calculation of Net Assets and NCI as on DOA**.
- (iii) Required changes means change in the value of recognised Assets and Liabilities or recognizing new Assets or Liabilities or derecognizing existing Assets or Liabilities.
- (iv) Any **difference** due to such changes are **adjusted in Goodwill/GBP**.
- (v) However, **after the measurement period ends**, any change in the value of assets and liabilities due to an information which existed on the valuation date will be accounted as an error as per Ind AS 8, Accounting policies, Changes in Accounting Estimates and Errors.

(Refer Q805 of FR Question Bank)

9. CONTROL OBTAINED WITHOUT THE TRANSFER OF CONSIDERATION (Ind AS 103)

- 1) The acquirer and acquiree agree to combine their businesses **by contract** alone.
- 2) For example, A Ltd. gets control over the business of B Ltd. through the agreement.
- 3) In such a case, **A Ltd. has not paid any consideration nor holds any equity interest** in B Ltd.
- 4) However, **A Ltd. takes all major decisions** of B Ltd.
- 5) Here, A Ltd. is treated as Acquirer and B Ltd. is treated as Acquiree.
- 6) Goodwill or Gain from bargain purchase shall be calculated as under:

| | |
|--|------------|
| Purchase Consideration | Nil |
| (+) Non-Controlling Interest (100%) | XXX |
| Fair Value of the Shares of B Ltd. | |
| (-) Fair Value of Net Assets of Acquiree Company | XXX |
| Goodwill or GBP (Capital Reserve) | XXX |

Such kind of business combinations which are achieved by contract alone are also called as

- "Bringing two businesses together in a **stapling arrangement**" or
- "Forming a **dual listed corporation**" (Refer Q511 of Question Bank)

Example 7:

A Ltd. obtained control over B Ltd. by contract alone. There is no stake in B Ltd. held by A Ltd. However, board members of B Ltd. consist of 5 Directors out of which 4 belongs to A Ltd. Fair Value of B Ltd. is Rs. 50 Lacs and FV of Net Assets of B Ltd. is 46 Lacs.

Solution:

A Ltd. is Acquirer. NCI has 100% Sharing with No Control. Hence NCI as per FV method is 50 Lacs. Purchase Consideration is Zero. Hence Goodwill is Rs. 4 Lacs.

10. CONSOLIDATION PROCESS (Ind AS 110)

- 1) **On Date of Acquisition (DOA):** Ind AS 103 is applied as discussed above.
- 2) **On Balance Sheet Date:** For the purpose of Consolidation, we have to follow Ind AS 110.
- 3) As per Ind AS 110, All Assets and Liabilities (as discussed earlier) of subsidiary company are consolidated with Holding company. (i.e. **100% Net Assets are recognised** even though holding has less than 100% sharing)
- 4) **NCI:** We have already discussed that NCI is required to be calculated on DOA, we must **remeasure the NCI as on Balance Sheet**.
- 5) Following workings are required for preparing Consolidated Balance Sheet:
 - a) Statement of Changes in Net Assets (SCNA) also called Analysis of Reserves of Subsidiary.
 - b) Calculation of Revised NCI as on Balance Sheet
 - c) Calculation of Consolidated Other Equity of Group (Also called Group Reserves)
- 6) **Statement of Changes in Net Assets:**
 - (i) We need Net Assets of Subsidiary as on DOA for the purpose of calculation of Goodwill or Gain from bargain purchase.
 - (ii) **Net Assets as on DOA = Equity Share Capital + Pre-Acquisition Profits**
 - (iii) We also require the Post Acquisition changes in subsidiary to prepare the Consolidated Balance Sheet.
 - (iv) Pre and Post Acquisition Profits can be found out with the help of below working:

| | Particulars | Net Assets as on DOA | Changes during the period | Total Balance as on CFS date |
|-----|---|----------------------|----------------------------------|------------------------------|
| | Balance of other equity (profits) of Subsidiary | | | |
| +/- | Bonus Issue | (XXX) always | + XXX Only if entry is passed | |
| +/- | Abnormal Items; Non-recurring items or Errors | - | XXX | |

| | | | | |
|-----|--|-------------------------------|--------------------------------|--|
| (+) | Equity or Preference Dividend paid during the year (or) Eq. or Pref. Dividend declared in CY & Entry Passed. | - | XXX | |
| = | Balances | XXX | XXX | |
| +/- | Time Adjustment (assume profit during the year is equal every month) **Time adjustment is made for Normal Profit after Tax before any appropriation like dividend, Bonus etc | XXX | XXX | |
| = | Balances after Time Adjustment | XXX | XXX | |
| +/- | Restate Abnormal Items | XX | XX | |
| (-) | Pref. Dividend by Subsidiary | XX | XX | |
| +/- | Revaluation of Assets/Liabilities along with Depreciation Effect | XXX | XXX | |
| +/- | DTA/DTL on above Revaluation & Dep. | XX | XX | |
| (-) | Elimination of Unrealized Profit & DTA thereof on Upstream Transaction | - | XX | |
| (-) | Additional Depreciation on Sale of PPE by Parent to Subsidiary on Unrealised Profit Portion | - | XX | |
| | Final Balances of Profits | Pre-Acquisition Profit | Post Acquisition Profit | |
| (+) | Equity Share Capital of Subsidiary (after Bonus issue always) | XXX | - | |
| | 100% Net Assets of Subsidiary as on DOA | XXX | - | |
| | Bifurcation of Post Acquisition Profit in Holding and NCI | - | H's Share NCI's Share | |

(Refer Practical Example 2)

7) Revised NCI as on Balance Sheet:

| | |
|--|-----|
| NCI as on Date of Acquisition (either FV method or Proportion of Net Assets Method) | XXX |
| (+/-) Share of NCI in Post Acquisition Profit/loss of Subsidiary (calculated from SCNA) | XXX |
| (-) Share of NCI in Dividend paid by subsidiary | XXX |
| (-) Share of NCI in Impairment Loss of Goodwill | XXX |

| | |
|--|-----|
| (if there is Full Goodwill and it is impaired in question) | |
| (-) NCI's Share in Investment by S1 in S2 (Chain Holding) | XXX |
| Balance of NCI as on Balance Sheet Date | XXX |

8) Calculation of Consolidated Other Equity of Group (Also called Group Reserves):

| Particulars | Retained Earnings (P&L) | Other Reserves | Total |
|---|-------------------------|----------------|-------|
| Reserves of Parent Company as per its SFS | XXXX | XXX | XXXX |
| (+/-) Rectification of Error if Any in Parent's P&L | XXX | - | XXX |
| (+/-) Share of Parent in Post Acquisition Profit/loss or OCI of Subsidiary. (Calculated from SCNA) | XXX | XX | XXX |
| (-) Share of Parent in Dividend Paid by Subsidiary | XX | - | XX |
| (+/-) Fair Value Gain/loss on Previous Investment (Step Acquisition) | XX | - | XX |
| (-) Elimination of Unrealised Profit in Downstream transaction | XX | - | XX |
| (+) Additional Dep. on Unrealised profit portion on upstream transaction of Sale of PPE | XX | - | XX |
| (-) Share of Parent in Goodwill Impairment if any | XX | - | XX |
| (+) Preference Dividend Share from Subsidiary Receivable if any | XX | - | XX |
| (+/-) Gain/Loss on Settlement of Investment in Debentures of Subsidiary (on cancellation of common debt portion) | XX | - | XX |
| (+/-) Gain/loss due to change in % of holding & change in NCI (without loss of control) Transfer to Separate Component of Equity) | - | XX | XX |
| (+/-) Gain/loss due to loss of control on sale of any subsidiary (charged to P&L) | XX | - | XX |
| (+/-) Any other Adjustment | XX | XX | XX |
| TOTAL | | | |

12. TREATMENT OF DIVIDEND (Ind AS 110)

1) Journal Entry of Dividend Declared and Paid by Subsidiary Co.:

| Dividend Declaration | Dividend Payment |
|--|---|
| Profit and Loss A/c Dr. To Dividend Payable A/c | Dividend Payable A/c Dr. To Bank A/c |

2) Holding Company is eligible for receipt of Dividend only if such dividend is paid by subsidiary **after** the date of acquisition.

3) Follow this guidance for treatment of Dividend:

| | |
|--|---|
| <p>Under AOP & Statement of Changes in Net Assets</p> | <ul style="list-style-type: none"> Add back in the statement of Net Assets (in Post acquisition column). Deduct the proportionate dividend directly from Consolidated Profit/loss of Grp and remaining dividend directly from NCI. When dividend is paid before DOA then deduct the dividend directly from Pre-acquisition Column. |
|--|---|

(Refer Practical Example No. 6, 7 & 8) (Also Refer 600 Series of Question Bank)

13. FAIR VALUE OF IDENTIFIABLE NET ASSETS (REVALUATION)

(Ind AS 110)

- 1) Net Assets shall be recognised **at Fair Value**.
- 2) But the formula of Net Assets is "Equity Share Capital + Other Equity".
- 3) This **formula covers the book value** of Net Assets only.
- 4) To find out fair value of Net Assets follow these steps:

| | | | | | | | |
|---|--|---|-----|---|------------|---|------------|
| Step 1 | <p><u>Calculate Revaluation Gain/Loss as on Date of Acquisition:</u></p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 80%;">Fair Value of Asset/liability as on DOA</td> <td style="text-align: right;">XXX</td> </tr> <tr> <td>(-) Book Value of Asset/liability as on DOA</td> <td style="text-align: right;"><u>XXX</u></td> </tr> <tr> <td>Revaluation Gain/Loss (for Pre-Acquisition Column)</td> <td style="text-align: right;">XXX</td> </tr> </table> | Fair Value of Asset/liability as on DOA | XXX | (-) Book Value of Asset/liability as on DOA | <u>XXX</u> | Revaluation Gain/Loss (for Pre-Acquisition Column) | XXX |
| Fair Value of Asset/liability as on DOA | XXX | | | | | | |
| (-) Book Value of Asset/liability as on DOA | <u>XXX</u> | | | | | | |
| Revaluation Gain/Loss (for Pre-Acquisition Column) | XXX | | | | | | |
| Step 2 | Calculate DTA/DTL effect on above Revaluation Gain/loss and adjust Pre-acquisition column | | | | | | |
| Step 3 | <p><u>Calculation Additional Depreciation or Saving in Depreciation due to Revaluation of Assets:</u></p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 80%;">Dep. on FV of Asset for Post Acquisition Period</td> <td style="text-align: right;">XXX</td> </tr> <tr> <td>(-) Actual Dep. Charged by Subsd. for Post Period</td> <td style="text-align: right;"><u>XXX</u></td> </tr> <tr> <td>Additional Dep./(Saving in Dep.)</td> <td style="text-align: right;">XXX</td> </tr> </table> | Dep. on FV of Asset for Post Acquisition Period | XXX | (-) Actual Dep. Charged by Subsd. for Post Period | <u>XXX</u> | Additional Dep./(Saving in Dep.) | XXX |
| Dep. on FV of Asset for Post Acquisition Period | XXX | | | | | | |
| (-) Actual Dep. Charged by Subsd. for Post Period | <u>XXX</u> | | | | | | |
| Additional Dep./(Saving in Dep.) | XXX | | | | | | |
| Step 4 | Calculate DTA/DTL effect on above Additional Dep. or Saving in Dep. and adjust Post acquisition column. | | | | | | |

| | | |
|---------------|--|------------|
| Step 5 | Under Consolidated Financial Statement: | |
| | Carrying Amount of Asset/Liability of Subsidiary | XXX |
| | (+/-) Revaluation Gain/loss | XXX |
| | (+/-) Additional Dep. or Saving in Dep. | <u>XXX</u> |
| | Fair Value of Net Assets as on BS date | XXX |

Note: All these Steps are to be followed after "Time Adjustment" in Analysis of Profit or Statement of Changes in Net Assets.

(Refer Practical Example No. 9 & 10)

14. UNREALISED PROFIT/LOSS ON INTRO GROUP TRANSACTION (Ind AS 110)

- 1) Intra group transaction means transaction between Holding company and Subsidiary company for Sale Purchase of Goods or Assets.
- 2) If Such transaction occurs other than at Cost then profit/loss element is required to be eliminated in Consolidated Financial Statement.
- 3) How to Eliminate the unrealized profit/loss:

| Sale/Purchase of Inventory (Goods) | |
|--|---|
| Unrealized Profit/loss = Sales Value of Unsold Good (-) Actual Cost of Unsold Goods | |
| Downstream Transaction (Goods sold by Holding to Subsidiary) | Upstream Transaction (Goods sold by Subsidiary to Holding) |
| <ul style="list-style-type: none"> ➤ Profit is earned by Holding company ➤ Eliminate unrealized profit from: <ul style="list-style-type: none"> ● Consolidated Retained Earnings of Group; & ● Balance Sheet Inventory Value ➤ Recognise DTA on elimination of unrealized Profit as under: <ul style="list-style-type: none"> ● Consolidated Balance Sheet; & ● Consolidated R/E of Group | <ul style="list-style-type: none"> ➤ Profit is earned by Subsidiary company ➤ Eliminate unrealized profit from: <ul style="list-style-type: none"> ● Post Acquisition Column of Statement of Changes in Net Assets; & ● Balance Sheet Inventory Value ➤ Recognise DTA on elimination of unrealized Profit as under: <ul style="list-style-type: none"> ● Consolidated Balance Sheet; & ● Post Acquisition Column of SCNA |

| Sale/Purchase of PPE | |
|---|---|
| Unrealized Profit/loss = Sales Value of PPE (-) Carrying Amt. of PPE on date of sale | |
| Downstream Transaction (PPE sold by Holding to Subsidiary) | Upstream Transaction (PPE sold by Subsidiary to Holding) |
| <ul style="list-style-type: none"> ➤ Profit is earned by Holding company ➤ Eliminate unrealized profit from: <ul style="list-style-type: none"> ● Consolidated Retained Earnings of Group; & ● Balance Sheet PPE Value | <ul style="list-style-type: none"> ➤ Profit is earned by Subsidiary company ➤ Eliminate unrealized profit from: <ul style="list-style-type: none"> ● Post Acquisition Column of Statement of Changes in Net Assets (SCNA); & ● Balance Sheet PPE Value |

- Recognise DTA on elimination of unrealized Profit as under:
- Consolidated Balance Sheet; &
 - Consolidated R/E of Group

Here, subsidiary would have charged depreciation on total sale value, in that case additional depreciation on unrealized profit portion should be eliminated as under:

- Add Post Acquisition Profit of Subsidiary in Statement of Changes in Net Assets; &
- Add PPE Value in Consolidated Balance Sheet

- Recognise DTA on elimination of unrealized Profit as under:
- Consolidated Balance Sheet; &
 - Post Acquisition Column of SCNA

Here, holding co. would have charged depreciation on total sale value, in that case additional depreciation on unrealized profit portion should be eliminated as under:

- Add Consolidated R/E of Group; &
- Add PPE Value in Consolidated Balance Sheet

Note:

Calculation of Additional Depreciation on unrealized profit portion:

| | |
|---|------------|
| Depreciation on Total Transaction Value of PPE sold | XXX |
| (-) Depreciation on Carrying Value for Seller | XXX |
| Additional Depreciation on Unrealised Profit Portion | XXX |

Example 8: (Unrealised Profit on Sale of PPE)

A Ltd. (which is involved in the business of selling capital equipment) a parent company sold a capital equipment costing ₹100 lakh to its 80% subsidiary B Ltd. At ₹120 lakh. The capital equipment is recorded as PPE by B Ltd. The useful life of the PPE on the date of transfer was 10 years. Show the necessary adjustment in the consolidated financial statements (CFS).

SOLUTION:

A Ltd. shall reduce the value of PPE of ₹120 lakh of B Ltd., by ₹20 lakh in CFS This will increase expenses and reduce consolidated profit by ₹20 lakh. Further, A Ltd. should also reduce the depreciation charge of B Ltd. to the extent of value of PPE reduced as above. Hence, A Ltd. should reduce the depreciation by ₹2 lakh (₹20 lakh ÷ 10 years). Further, the sales and cost of goods sold recorded by parent A Ltd. shall also be eliminated.

The double entry on consolidation is as follows:

| | | ₹in lakhs | |
|----------------------|-----|-----------|-----|
| | | Dr. | Cr. |
| Consolidated revenue | Dr. | 120 | |
| To Cost of sales | | | 100 |
| To PPE | | | 18 |
| To Depreciation | | | 2 |

Alternative Journal Entry for above transaction based on BS approach:

| | | ₹in lakhs | |
|-----------------------------------|-----|-----------|-----|
| | | Dr. | Cr. |
| Consolidated P&L of A Ltd. | Dr. | 20 | |
| To PPE A/c | | | 18 |
| To Consolidated P&L of A Ltd. A/c | | | 1.6 |
| To NCI A/c | | | 0.4 |

(Refer 900 Series of Question Bank)

15. STEP ACQUISITIONS (Ind AS 103)

- 1) Step Acquisition means acquiring equity interest in subsidiary **at various different dates** let's say acquired first time in the year 20X1 @ 20% then acquired another 40% in the year 20X2. In this case, CONTROL is meant to be acquired in the year 20X2.
- 2) Consolidation begins **only from the date of obtaining control**.
- 3) **Investments held before obtaining control (Previous Equity interest held) must be revalued at Fair value as on DOA.**
- 4) Gain or Loss due to above revaluation is transferred to **Consolidated P&L** of Group.
- 5) How to Calculate FV of Previous Investments?

First Preference - FV will be provided in the question

Second Preference - Compute FV based on Price per share paid by Parent in its latest acquisition (i.e. on DOA of Control)

Purchase Consideration discharged by Acquirer X Previous Holding %

Newly Acquired % by Acquirer

6) Journal Entry:

| | |
|---|---|
| Revalue the Previously held Investment at Fair Value (in CFS) | Investment A/c Dr. To Gain (Cons. P&L) A/c Loss P&L A/c Dr. To Investment A/c |
| Recognizing Net Assets, NCI and Goodwill/CR as on DOA | Net Assets (100%) Dr. (at Fair Value) Goodwill A/c Dr. To NCI A/c To Bank A/c (Paid on Further Acquisition) To Investment A/c (at Fair Value) |

7) Previous Investment held by Acquirer is 20% or More i.e. Acquiree is Associate Co. before obtaining Control:

| | | | | | | | |
|--|--|--------------------|-----|-----------------------------------|-----|-----------------------------------|-----|
| Investment before obtaining Control 20% or More in Acquiree (also called Associate Co.) | Equity Method must have been applied in CFS on such Investment as Under: | | | | | | |
| | <table style="width: 100%; border: none;"> <tr> <td style="width: 60%;">Cost of Investment</td> <td style="text-align: right;">XXX</td> </tr> <tr> <td>(+) Share of Post Acquisition P&L</td> <td style="text-align: right;">XXX</td> </tr> <tr> <td>(+) Share in Post Acquisition OCI</td> <td style="text-align: right;">XXX</td> </tr> </table> | Cost of Investment | XXX | (+) Share of Post Acquisition P&L | XXX | (+) Share in Post Acquisition OCI | XXX |
| Cost of Investment | XXX | | | | | | |
| (+) Share of Post Acquisition P&L | XXX | | | | | | |
| (+) Share in Post Acquisition OCI | XXX | | | | | | |

| | | | | | | | | | | | | | | | |
|---|---|---------------|---------------------|----------------------|----------------|--------------------|-----|-------------|-------------------------------|-------------------|-----------------------|--------------------------|-------------------|-------------------------|------------------|
| | <p>Value of Investments (in CFS) XXX</p> <p>Journal Entry: Investment A/c Dr. To Consolidated P&L A/c To Consolidated OCI A/C</p> | | | | | | | | | | | | | | |
| <p>Subsequently when Associate is converted in Subsidiary due to further acquisition</p> | <p>1) Equity Method will be discontinued and Ind AS 103 shall be followed.</p> <p>2) Follow Step Acquisition Method and Measure previous Investment in Associates at FV as on DOA.</p> <p>3) Any Accumulated Balances in OCI shall be treated as Follows:</p> <ul style="list-style-type: none"> • Balance of OCI to the extent allowed as reclassified shall be transferred to Consolidated P&L A/c • Balance of OCI to the Extent not allowed to be reclassified - shall be directly transferred to retained earnings in CFS. <p>Journal Entry as on Date of Acquisition of Control:</p> <table> <tr> <td>Net Asset A/c</td> <td>Dr. (At Fair Value)</td> </tr> <tr> <td>Consolidated OCI A/c</td> <td>Dr. (Reversal)</td> </tr> <tr> <td>Goodwill / GBP A/c</td> <td>Dr.</td> </tr> <tr> <td> To Bank A/c</td> <td>(Paid on Further Acquisition)</td> </tr> <tr> <td> To Investment A/c</td> <td>(Previous Investment)</td> </tr> <tr> <td> To Retained Earnings A/c</td> <td>(Conso. OCI Bal.)</td> </tr> <tr> <td> To Consolidated P&L A/c</td> <td>(balancing Fig.)</td> </tr> </table> | Net Asset A/c | Dr. (At Fair Value) | Consolidated OCI A/c | Dr. (Reversal) | Goodwill / GBP A/c | Dr. | To Bank A/c | (Paid on Further Acquisition) | To Investment A/c | (Previous Investment) | To Retained Earnings A/c | (Conso. OCI Bal.) | To Consolidated P&L A/c | (balancing Fig.) |
| Net Asset A/c | Dr. (At Fair Value) | | | | | | | | | | | | | | |
| Consolidated OCI A/c | Dr. (Reversal) | | | | | | | | | | | | | | |
| Goodwill / GBP A/c | Dr. | | | | | | | | | | | | | | |
| To Bank A/c | (Paid on Further Acquisition) | | | | | | | | | | | | | | |
| To Investment A/c | (Previous Investment) | | | | | | | | | | | | | | |
| To Retained Earnings A/c | (Conso. OCI Bal.) | | | | | | | | | | | | | | |
| To Consolidated P&L A/c | (balancing Fig.) | | | | | | | | | | | | | | |

Example 9: (Step Acquisition)

Invested 15% in Equity of B Ltd on 1/4/22 @ 5,00,000/-

Total Equity Shares outstanding of B Ltd. is 1,00,000 No.

Invested another 45% in equity of B Ltd on 1/4/23 @25,00,000/-

Market Value of Share of B Ltd. on 1/4/23 is 50/-

100% Net Assets Fair Value of B Ltd.

1/4/22 = 50,00,000

1/4/23 = 60,00,000

NCI Should be at Fair Value

Calculate COC & also discuss treatment of 15% Investment in CFS.

(Parent Follows Cost model under INDAS 27)

Solution:

Date of Acquisition = 1/4/23

Cost of Control:

| | |
|-----------------------------------|------------------|
| Investment (PC) | |
| 1/4/23 - 45 % Equity | 25,00,000 |
| | 7,50,000 |
| 1/4/22 - 15% Equity (15,000 × 50) | 32,50,000 |
| + NCI as on DOA (40,000 × 50/-) | 20,00,000 |
| (-) 100% Net Assets | (60,00,000) |
| Gain on Bargain Purchase | 7,50,000 |

While calculating GBP as above, we have remeasured 15% Investment @7,50,000 (i.e., FV Gain of 2,50,000). Its second effect should be credited to P&L of parent & to be reflected in Consolidated Other Equity of Grp.

(Refer 800 Series of Question Bank)

16. IMPAIRMENT OF GOODWILL (Ind AS 110)

Journal Entry in CFS

| Full Goodwill | | Partial Goodwill | |
|------------------------------------|-----|------------------------------------|-----|
| Consolidated Retained Earnings A/c | Dr. | Consolidated Retained Earnings A/c | Dr. |
| NCI A/c | Dr. | To Goodwill A/c | |
| To Goodwill A/c | | | |

(Refer Q1404 and Q1405 of Question Bank)

17. REVERSE ACQUISITION (Ind AS 103)

- Under Reverse Acquisition, the entity who actually discharge the Purchase consideration is not the acquirer company for accounting purposes.
- Acquirer company is the one who actually gets control.
- Types of Reverse Acquisition:
 - Acquisition through Shares
 - Merger of Two or more companies in which one existing company has obtained control over the Newly Merged Company.
- Reverse Acquisition through Shares:**

| | |
|----------------|---|
| Example | <p>X Ltd. acquired the business of Y Ltd. X Ltd. will issue to the shareholders of Y Ltd. 5 shares of Rs. 10 each for every 2 shares held in Y Ltd. No. of O/s shares in X Ltd. are 7,500 shares. No. of O/s shares in Y Ltd. are 5,000 shares. Fair Value per share of Y Ltd. is 20/-</p> <p>Here, X Ltd. shall issue 12,500 no. of shares $[(5,000 \div 2) \times 5]$ to the shareholders of Y Ltd. Hence, the total outstanding shares of X Ltd. after this transaction will become 20,000 no. Out of 20,000 no. of shares of X Ltd.,</p> |
|----------------|---|

| | | | | | |
|--|---|--------------------------------|-----------|-----------------------------------|------------|
| | <p>12,500 shares are held by Y (shareholders of Y) that comes to approx. 62.5% holding in X Ltd.</p> <p>Conclusion:</p> <ul style="list-style-type: none"> Y Ltd. has 62.5% holding in X Ltd. hence Y Ltd. is called Accounting Acquirer who gets control over X Ltd. X Ltd. is treated as Accounting Acquiree (Legal Acquirer) because it is controlled by Y Ltd. | | | | |
| Who will apply Ind AS 103 | Accounting Acquirer (Y Ltd.) shall apply acquisition method of Ind AS 103. Accounting Acquirer (Y Ltd.) has to calculate Deemed Purchase Consideration also called Notional PC. | | | | |
| Deemed PC or Notional PC | <p>Step 1:</p> <p style="text-align: center;"><u>Total No. of Equity Shares in ESC of Accounting Acquirer (Y Ltd.)</u> % of Holding of Accounting Acquirer in Legal Acquirer Ltd.</p> <p style="text-align: center;">$5,000 \div 62.5\% = 8,000 \text{ No.}$</p> <p>Step 2:</p> <p>Step 1 (-) Total No. of Equity Shares in ESC of Accounting Acquirer (Y Ltd.) $8,000 - 5,000 = 3,000 \text{ No.}$</p> <p>Step 3:</p> <p>Deemed PC = Step 2 X Fair Value per share of Accounting Acquirer $3,000 \times 20 = 60,000$</p> <p>60,000 no. will be assumed as Deemed PC to be issued by Accounting Acquirer (Y Ltd.) to X Ltd. (Accounting Acquiree)</p> | | | | |
| Accounting | <ul style="list-style-type: none"> Net Assets of Accounting Acquiree (Legal Acquirer i.e. X Ltd.) are taken over at Fair Value NCI will be Zero Goodwill or Capital Reserve will be Deemed PC less Net Assets at Fair Value | | | | |
| Consolidation | <ul style="list-style-type: none"> Consolidated Financial Statements shall be prepared in the name of Legal Acquirer i.e. X Ltd. Net Assets of Accounting Acquiree at Fair Value plus Net Assets of Accounting Acquirer (Y Ltd.) at same book value Equity Share Capital of Combined Entity will be Original Legal Shares: <table style="width: 100%; border: none;"> <tr> <td style="padding-left: 20px;">ESC of Legal Acquirer (X Ltd.)</td> <td style="text-align: right;">7,500 no.</td> </tr> <tr> <td style="padding-left: 20px;">(+) Equity Shares actually issued</td> <td style="text-align: right;">12,500 no.</td> </tr> </table> | ESC of Legal Acquirer (X Ltd.) | 7,500 no. | (+) Equity Shares actually issued | 12,500 no. |
| ESC of Legal Acquirer (X Ltd.) | 7,500 no. | | | | |
| (+) Equity Shares actually issued | 12,500 no. | | | | |
| Calculation of EPS of Combined Entity | <p>Sometimes questions may ask to calculate the EPS. It is to be calculated as under:</p> <p>Formulae of EPS =</p> <p style="text-align: center;">Earnings Available to ESH \div W. Avg. No. of Equity Shares</p> | | | | |

| | |
|--|--|
| | <p>(a) <u>Earnings Available to ESH:</u> EAESH of Accounting Acquirer for a period before Business Combination (+) EAESH of Combined Entity after Business Combination</p> <p>(b) <u>W. Avg. No. of Equity Shares:</u> Legal no. shares in the combined entity issued to Accounting Acquirer for full year (+) Legal no. Shares with legal Acquirer for Post Combination Period only</p> |
|--|--|

5) Reverse Acquisition through Merger of Two or More Companies:

| | |
|----------------------------------|--|
| Example | <ul style="list-style-type: none"> • X Ltd. and Y Ltd merged and formed a New Company XY Ltd. • Fair Value of X Ltd. is 50,000 and Fair Value of Y Ltd. is 75,000. • Board of Directors of XY Ltd. consist of 4 Directors of X Ltd. and 6 Directors of Y Ltd. Hence Y Ltd. is treated as Acquirer. • % of Fair Value of Y in the combined Fair Values is more than 50% hence it is a case of Reverse Acquisition $(75,000/1,25,000) \times 100 = 60\%$ • Y Ltd. holds 60% share in XY Ltd. Hence XY Ltd. and X Ltd. are treated as Accounting Acquiree. |
| Who will apply Ind AS 103 | Accounting Acquirer (Y Ltd.) shall apply acquisition method of Ind AS 103. Accounting Acquirer (Y Ltd.) has to calculate Deemed Purchase Consideration also called Notional PC. |
| Deemed PC or Notional PC | Fair Value of Acquiree Co. (X Ltd.) will be assumed as Deemed PC i.e. 50,000 Suppose the MP per share of Y Ltd. is 20/- Y Ltd. should issue 2,500 no. of shares as Deemed PC |
| Accounting | <ul style="list-style-type: none"> • Net Assets of Accounting Acquiree (Legal Acquirer i.e. X Ltd.) are taken over at Fair Value • NCI will be Zero • Goodwill or Capital Reserve will be Deemed PC less Net Assets at Fair Value |
| Consolidation | <ul style="list-style-type: none"> • Consolidated Financial Statements shall be prepared in the name of the Merged Entity i.e. XY Ltd. • Net Assets of Accounting Acquiree (X Ltd.) at Fair Value plus Net Assets of Accounting Acquirer (Y Ltd.) at same book value |

Example 10: - (Identifying Accounting Acquirer)

Idea Ltd. acquired the Net Assets of Vodafone & issued shares as a consideration.

Idea issues 5 shares for every 2 Held by Share Holders of Vodafone

Outstanding Shares of Vodafone is 1,00,000 No.

Outstanding Shares of Idea is 50,000 No.

Who is Accounting Acquirer & Legal Acquirer?

Solution:

Idea shall issue to Vodafone Share Holders = $1,00,000/2 \times 5 = 2,50,000$ No.

Now, after above issue, Total Outstanding Equity Shares of Idea will be $50,000 + 2,50,000$ No. i.e., 3,00,000 No.

Who are the Share Holders of Idea?

50,000 No. Held by Old Share Holders of Idea = 16.67%

2,50,000 No. Held by New Share Holders of Idea who were earlier Shareholders in Vodafone = 83.33%

Since Share Holders of Vodafone are having 83.33% Voting Rights It can be said that Vodafone is Accounting Acquirer.

Idea is Accounting Acquiree although Idea is a Legal Acquirer

Balance Sheet of Idea Ltd. & Group

| | |
|-------------------|------|
| Asset | |
| Vodafone (CA) | xxxx |
| Idea (Fair Value) | |
| Liabilities | |
| Vodafone (CA) | xxxx |
| Idea (Fair Value) | |

Example 11: (PC in case of Reverse Acquisition)

How to Calculate the PC that should be discharges by Vodafone against Control

FV of one Share: -

Idea = 40/-

Vodafone = 75/-

Since Vodafone gets 83.33% in Idea.

Vodafone Existing Outstanding Shares = 1,00,000

$1,00,000 / 83.33\% \times 16.67\% = 20,000$ No.

Vodafone should have issued 20,000 No. to Obtain Control & Voting Rights over Idea

PC = $20,000 \times 75/- = 15,00,000/-$

Example 12: (Goodwill/GBP in case of Reverse Acquisition)

Calculate Goodwill / Gain on Bargain Purchase if FV of Net Assets of Idea is 14,20,000

Solution:

| | |
|---------------------------------|-------------|
| PC to Acquiree | 15,00,000 |
| (+) NCI | - |
| (-) 100% Net Assets | (14,20,000) |
| Goodwill (Only for A/c Purpose) | 80,000 |

(Also Refer Practical Example no. 11 & 1300 Series of Question Bank)

18. COMMON CONTROL BUSINESS COMBINATIONS

(Ind AS 103)

1) What is Common Control Business Combination (CCBC)?

- Common control business combinations means a business combinations where **control doesn't transfer to another party**.
- Control over the business **is retained with the same party** (before and after Acquisition).
- Example: transfer of subsidiaries or businesses, between entities within a group.
- It is **not an actual business acquisition**; it is a corporate restructuring.

2) Examples of CCBC:

| | |
|---|--|
| Group of Individuals | <p>A Ltd. and B Ltd. are owned by four Shareholders P, Q, R & S, each of whom holds 25% of the shares of each company.</p> <p>There is an agreement between P, Q & R for governance of A Ltd. and B Ltd. by which they exercise joint control.</p> <p>A Ltd. and B Ltd. are under common control of P, Q & R since they combine have 75% shareholding through agreement.</p> |
| Transfer of one subsidiary to another subsidiary | <ul style="list-style-type: none"> • Holding Ltd. has two subsidiaries, S1 Ltd. and S2 Ltd. • Holding Ltd. sold its investment in S2 Ltd. to S1 Ltd. • Now Holding Ltd. has one Subsidiary S1 Ltd. • S1 Ltd. has one subsidiary S2 Ltd. • S2 Ltd. is ultimately controlled by Holding Ltd. before or after the acquisition. |

3) Accounting Under CCBC?

- a) The seller entity/entities are called Transferor company, and the acquirer entity is called transferee company.
- b) Transferee company shall apply "**Pooling of interests method**"
- c) **Pooling of Interest Method:**
 - All Assets and Liabilities including reserves of transferor company shall be recorded at **same Carrying Amount** (book value);
 - Compare Purchase Consideration amount with above Net Assets and Reserves recognised.
 - The difference will be **transferred to Capital reserve** (Gain/loss)
 - **Journal Entry:**

| | | |
|--|-----|---------------|
| Assets A/c | Dr. | Book Value |
| Loss on Restructuring A/c (Capital Reserves) | Dr. | (Bal. fig.) |
| To Liabilities A/c | | Book Value |
| To Reserves of Transferor A/c | | Book Value |
| To Purchase Consideration A/c | | As calculated |
| To Gain on Restructuring A/c (Capital Reserve) | | (Bal. fig.) |

4) Types of Common Control Business Combinations:

| Merger of Two Companies | Transfer of One Division to Another Existing Company |
|---|--|
| Here, two companies merged and form a New Company. New Company is controlled by the members of both the old companies. | Here, one unit/division/segment of a company is transferred to a company. Such purchasing company issues Shares to the Share Holders of Existing Company, because of which, the Share Holders of existing company gets Control over the Purchasing Company i.e. Control over the Transferred Division is not Shifted. It Exist with Same Members of Group. |
| Purchase Consideration: If PC is not given in the Question, then PC will be equal to Sum of ESC of Both Companies. This PC is then allocated in proportion of Book Value of Net Assets Taken Over. | Purchase Consideration: PC must be given in the form of exchange of shares. |

5) Restate Financial Statement of Prior Period:

- Prior Period financial statements are required to be restated as if business combination has occurred from the beginning of the preceding period, irrespective of the actual date of combination.
- However, if actual common control starts after the beginning of PY, then prior period information shall be restated only from that date.

(Also Refer 1200 Series of Question Bank)

19. DEMERGER (Ind AS 103)

- 1) **Demerger** is an arrangement whereby one division/segment of the entity (Demerged Company) is transferred to Newly incorporated Entity (Resultant Company).
- 2) **Shareholders of the original company may lose the control** over the transferred division.
- 3) **Accounting Treatment**

➤ **Demerged company Books:** Derecognition of Assets and Liabilities:

| | | |
|-----------------------------|-----|--------------|
| Liabilities A/c | Dr. | (Book Value) |
| Loss due to Demerger A/c | Dr. | (b/f) |
| To Assets A/c | | Book Value |
| To Gain due to Demerger A/c | | (b/f) |

➤ **Resultant Company:**

- It **gets control** over the transferred division hence it shall follow "**Acquisition method**" of Ind AS 103.
- If the control over transferred division **exists with the same company** even after the demerger, then this transaction is treated as **CCBS and Pooling of Interest Method** shall be followed.
- **Accounting as per Acquisition Method for Resulting Company:**

| | | |
|----------------------------|-----|--------------|
| Assets A/c | Dr. | (Fair Value) |
| Goodwill A/c | Dr. | (b/f) |
| To Liabilities A/c | | (Fair Value) |
| To Bank A/c | | (PC) |
| To ESC and Sec Premium A/c | | (PC) |
| To Capital Reserve A/c | | (b/f) |

(Refer Q1503 of Question Bank)

20. CHAIN HOLDING (Ind AS 110)

1) Example of Chain Holding:

- Parent has Acquired 80% shares in Subsidiary 1 (S1)
- Subsidiary (S1) has Acquired 70% shares in Subsidiary 2 (S2)

2) Entire procedure for Consolidation is same as discussed above with one additional adjustment as under:

| Carrying Amount of Investment Made by S1 in S2 is divided into two parts E.g. Investment by S1 in S2 is 1,00,000 | |
|---|---|
| Share of P in such investment say 80% i.e. 80,000 | Share of NCI of S1 say 20% i.e. 20,000 |
| Under COC Working of S2, Take Investment Cost at 80,000 | Under NCI working of S1, this share of NCI i.e. 20,000 is deducted from total amount. |

Example 13:

Balance Sheets (Extract)

| Particulars | P | S1 | S2 |
|--------------------|----------|----------|----|
| Investments | | | |
| By P in S1 (80%) | 5,00,000 | - | - |
| By S1 in S2 (70%) | - | 3,00,000 | - |

Solution:

1. Cost of Control (Extract)

| Particulars | COC for S1 | COC for S2 |
|---|------------|------------|
| Investment (PC) by P in S1 | 5,00,000 | - |
| Investment (PC) by P in S2 (P's share 80%) (share of P in Investment made by S1 in S2) | - | 2,40,000 |

2. Non-controlling Interest (Extract)

| Particulars | NCI of S1 | NCI of S2 |
|--|-----------|-----------|
| NCI working as usual | - | - |
| (-) Share of NCI of S1 in Investment Made by S1 in S2 | (60,000) | - |

Reason: This is because 60,000 Investment of S1 doesn't belong to Parent, it belongs to other shareholders of S1 (i.e. NCI of S1) and it has a debit balance. Overall NCI is credit balance therefore it is setoff.

(Refer Practical Example 12 and Series 1100 of Question Bank)

21. CHANGE IN % OF HOLDING OF PARENT CO. (Ind AS 110)

Case 1: Purchase of Additional shares in Subsidiary after DOA

| | |
|---------------------------------------|--|
| Impact on NCI | NCI % shall be reduced Proportionately. |
| Journal Entry in SFS of Parent | Investment A/ Dr. To Bank A/c |
| Journal Entry in CFS of Parent | NCI A/c Dr. (Proportionately) To Bank A/c (Any Difference in above entry is transferred to Consolidated Other Equity of Group) |

Case 2: Sale of Shares in Subsidiary after DOA (with "No Loss of Control")

| | |
|---------------------------------------|---|
| Impact on NCI | <ul style="list-style-type: none"> NCI % shall be Increased. Increase in NCI = % of Sale X (Net Assets + Goodwill as on Date of Sale) |
| Journal Entry in SFS of Parent | Bank A/c Dr. To Investment A/c (Proportionate Carrying Amt) (Any Difference in above is Gain/Loss on Sale and transferred to Profit and Loss A/c) |
| Journal Entry in CFS of Parent | Bank A/c Dr. To NCI A/c (increase in NCI) (Any Difference in above entry is transferred to Consolidated Other Equity of Group) |

Case 3: Sale of Shares in Subsidiary after DOA (with "Loss of Control")

| | |
|--|---|
| Impact on CFS | <ul style="list-style-type: none"> Derecognise carrying amount of Net Assets of Subsidiary as on date of Sale Derecognise Goodwill as on date of sale Derecognise carrying amount of NCI on date of sale Recognise Amount received for sale of Investment (Bank A/c) Recognise Retained Investment in Subsidiary at Fair Value Any difference due to above adjustment is transferred to Profit and Loss A/c |
| How to Calculate the Fair Value of Retained Investments | Either it will be given in the question; or It is calculated as under: "Sale Value of Investments" X "% retained" ÷ "% Sold" |
| How to Calculate the Carrying | 1) <u>If NCI is based on Fair Value</u> Carrying Amt. of (Net Assets + Goodwill) X NCI % |

| | | | | | | | | | | | |
|---|--|--------------|-----------------|-------------|-----------------|---------------------|-------------------------------|-------------------|-----------------|-----------------|-----------------|
| Value of NCI to be derecognized | 2) <u>If NCI is based on Proportionate Share of Net Assets</u> Carrying Amt. of Net Assets X NCI % | | | | | | | | | | |
| Journal Entry in CFS of Parent | <table border="0"> <tr> <td>Bank A/c Dr.</td> <td>(Sale Proceeds)</td> </tr> <tr> <td>NCI A/c Dr.</td> <td>(Carrying Amt.)</td> </tr> <tr> <td>Investments A/c Dr.</td> <td>(Retained Part at Fair Value)</td> </tr> <tr> <td> To Net Assets A/c</td> <td>(Carrying Amt.)</td> </tr> <tr> <td> To Goodwill A/c</td> <td>(Carrying Amt.)</td> </tr> </table> <p>(Any Difference in above entry is transferred to Profit and Loss A/c)</p> | Bank A/c Dr. | (Sale Proceeds) | NCI A/c Dr. | (Carrying Amt.) | Investments A/c Dr. | (Retained Part at Fair Value) | To Net Assets A/c | (Carrying Amt.) | To Goodwill A/c | (Carrying Amt.) |
| Bank A/c Dr. | (Sale Proceeds) | | | | | | | | | | |
| NCI A/c Dr. | (Carrying Amt.) | | | | | | | | | | |
| Investments A/c Dr. | (Retained Part at Fair Value) | | | | | | | | | | |
| To Net Assets A/c | (Carrying Amt.) | | | | | | | | | | |
| To Goodwill A/c | (Carrying Amt.) | | | | | | | | | | |
| Reclassification of OCI | <p>Parent's share in OCI reserve of subsidiary company shall be reclassified to either P&L or directly to retained earnings depending on Nature of OCI reserve:</p> <ul style="list-style-type: none"> ● Revaluation Reserve of Subsidiary - Transfer to Retained Earnings ● FCTR of Subsidiary - Transfer to P&L ● Actuarial Gain/Loss of Subsidiary - Transfer to Retained Earnings | | | | | | | | | | |
| Loss of Control in two or more transactions | <p>Treat all transactions as "Single Transaction" only when it fulfills below conditions:</p> <ul style="list-style-type: none"> ● All Transactions are entered into near the same time ● All transactions form a single transaction designed to achieve overall objective ● One transaction considered on its own is not economically justified unless it is considered together with another transaction | | | | | | | | | | |

(Refer Practical Example 13 and also Refer Series 1000 of Question Bank)

21. BUSINESS ACQUISITION VS. ASSET ACQUISITION

(Ind AS 103)

- 1) Ind AS 103 applies to Business Acquisition and not to Asset Acquisition.
- 2) Asset Acquisition accounting is applicable under Ind AS 16, 38, 40 etc.
- 3) Sometimes it's very difficult to identify whether the transaction contains Business Acquisition or Asset Acquisition.
- 4) Business means integrated set of activities having three important elements:
 - a) **Inputs:** means Assets and other resources required to generate output
 - b) **Processes:** means techniques, decision making, management skills used to generate outputs
 - c) **Outputs:** Revenue generated by using Inputs and Processes.
- 5) However, in many cases, **outputs are not necessarily available always** to treat the transaction as Business acquisition.
- 6) To identify the transaction as Business Acquisition, entity has to follow below conditions:

| If set of activities and assets have outputs | If set of activities and assets doesn't have output |
|---|--|
| <p>Is the Process critical to produce outputs and inputs include workforce then acquired Assets are considered as Business Acquisition.</p> <p style="text-align: center;">(OR)</p> <p>Is the Process significantly contribute to the ability to produce output and such process is scarce/unique/hard to replace, if yes then it is business acquisition.</p> | <p>Is the Process critical to develop/covert inputs into outputs (AND)</p> <p>Input includes workforce and other inputs that workforce can convert to outputs, if yes then it is business acquisition.</p> |
| <p>Examples:</p> <p>Acquired a Running Business Yes, it is Business Acquisition (because it has Input, Substantive Process & Output)</p> <p>Acquired a company with following items: Production Plant (Factory) with skilled workforce Intellectual Property Rights (Patents) essential to earn revenue. However the company has not yet started earning revenue. <u>Conclusion: it is a business acquisition</u></p> <p>Acquired an under Constructed Factory Building (No workforce is yet appointed) It's an Asset Acquisition</p> | |

7) Concentration Test:

- Instead of assessing whether you have inputs, substantive process and all other features of business, Ind AS 103 introduced **new simplification option called Concentration Test.**

- It is an optional test to determine whether acquired set of activities and Assets is a Business Acquisition or Asset Acquisition.
- **If Concentration test is passed, then the transaction is treated as Asset Acquisition.**
- If Concentration test is failed, then further analysis is required as per above conditions of point no. 6
- If the **Fair Value of Gross Assets** Acquired is **substantially concentrated in as Single Asset**, the test is passed hence such acquisition is treated as "Asset Acquisition".
- Apply following steps for concentration test:

| | | | | | | | | | | | | | |
|--|--|---------------------------------|-----|--|-----|---------------|-----|--|-----|-------------------------------|-------|---------|-------|
| Step 1: | <p><u>Calculate Fair Value of Gross Assets Acquired as Under:</u></p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 80%;">FV of Consideration Transferred</td> <td style="text-align: right;">XXX</td> </tr> <tr> <td>(+) FV of Previously acquired interest</td> <td style="text-align: right;">XXX</td> </tr> <tr> <td>(+) FV of NCI</td> <td style="text-align: right;">XXX</td> </tr> <tr> <td>(+) FV of Liabilities Acquired (excluding DTL)</td> <td style="text-align: right;">XXX</td> </tr> <tr> <td>(-) Cash and Cash Equivalents</td> <td style="text-align: right;">(xxx)</td> </tr> <tr> <td>(-) DTA</td> <td style="text-align: right;">(xxx)</td> </tr> </table> | FV of Consideration Transferred | XXX | (+) FV of Previously acquired interest | XXX | (+) FV of NCI | XXX | (+) FV of Liabilities Acquired (excluding DTL) | XXX | (-) Cash and Cash Equivalents | (xxx) | (-) DTA | (xxx) |
| FV of Consideration Transferred | XXX | | | | | | | | | | | | |
| (+) FV of Previously acquired interest | XXX | | | | | | | | | | | | |
| (+) FV of NCI | XXX | | | | | | | | | | | | |
| (+) FV of Liabilities Acquired (excluding DTL) | XXX | | | | | | | | | | | | |
| (-) Cash and Cash Equivalents | (xxx) | | | | | | | | | | | | |
| (-) DTA | (xxx) | | | | | | | | | | | | |
| Step 2: | Identify the Single or Group of Similar Assets taken over whose fair value is highest among other assets. | | | | | | | | | | | | |
| Step 3: | <p>Calculate the % of Concentration of Single Asset into Gross Assets as under:</p> $\frac{\text{FV of Single Asset (Step 2)}}{\text{FV of Gross Asset (Step 1)}} \times 100$ <p>If the above percentage is 90% or More, then the concentration test is passed. It will be considered as Asset Acquisition</p> | | | | | | | | | | | | |

Example 14: (Concentration Test)

Acquired a Business of other entity at PC of 100 Crore, having Net Assets as under:
Land & Building= 95 Crore, and combined value of Vehicle, Furniture and Debtors = 4 Cr.

Solution:

$$95 / 100 \times 100 = 95\%$$

PC is Substantially Concentrated towards Land Only i.e., More than 90%

Concentration test is passed. It is not Business Acquisition.

Example 15: (Concentration Test)

Entity A holds 20% interest in Entity B. Subsequently Entity A, further acquires 50% share in Entity B by paying 300 Crores.

The fair value of assets acquired and Liabilities assumed are as follows:

| | |
|--------------------------|---------------|
| Building | - 1000 Crores |
| Cash and Cash Equivalent | - 200 Crores |
| Financial Liabilities | - 800 Crores |
| DTL | - 150 crores |

Fair value of Entity B is 400 Crores and Fair value of NCI is 120 Crores ($400 \times 30\%$)

Fair value of Entity A's previously held interest is 80 Crores ($400 \times 20\%$)

Entity A needs to determine whether acquisition is an asset acquisition as per concentration test.

- i) Fair value of consideration transferred (including fair value of non-controlling interest and fair value of previously interest held) = $300 + 120 + 80 = 500$ Crores
- ii) Fair value of liability assumed (excluding deferred tax) = 800 crores
- iii) Cash and cash equivalent = (200) crores.

Fair value of Gross Assets acquired 1100 Crores.

Fair Value of Building is 1000 Crores

In the above scenario, substantially all fair value of gross assets acquired is concentrated in a single identifiable asset i.e. building. Hence it should be asset acquisition. ($1,000 / 1,100 = 91\%$ of value of gross assets is concentrated into single identifiable asset i.e. building).

(Refer Practical Example 14 & Also Refer Series 100 of FR Question Bank)



Student Notes:-

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IND AS 110 – CONSOLIDATED FINANCIAL STATEMENTS

“Sit with winners, the conversation will be different”

1. What is CONTROL?

Simply speaking, the basic rule is:

- If an investor **controls** its investee => investor must consolidate;
- If an investor **does NOT control** its investee => investor **does NOT** consolidate.

So what is control?

An investor **controls** an investee when the investor:

- Is exposed to, or has right to **variable returns** from its involvement with the investee;
- Has the **ability to affect** those returns
- Through its **power** over the investee.

| | |
|---|---|
| If Control exist with single entity | Apply IndAS 110 (Consolidated Financial Statements) |
| If Control exist with More than one Entity through an agreement, then it is Joint Control | Apply IndAS 111 & 28 (Joint Arrangements and Investment in JV) |

2. POWER

Power is the existing rights that give the current ability to direct the relevant activities. Let's break it down a bit:

- The rights must be **substantive** (i.e. Major Rights)
- The relevant activities must be **significant** and related to major activities of the investee.

Examples of activities related to operating and financing activities that can be relevant activities include, but not limited to:

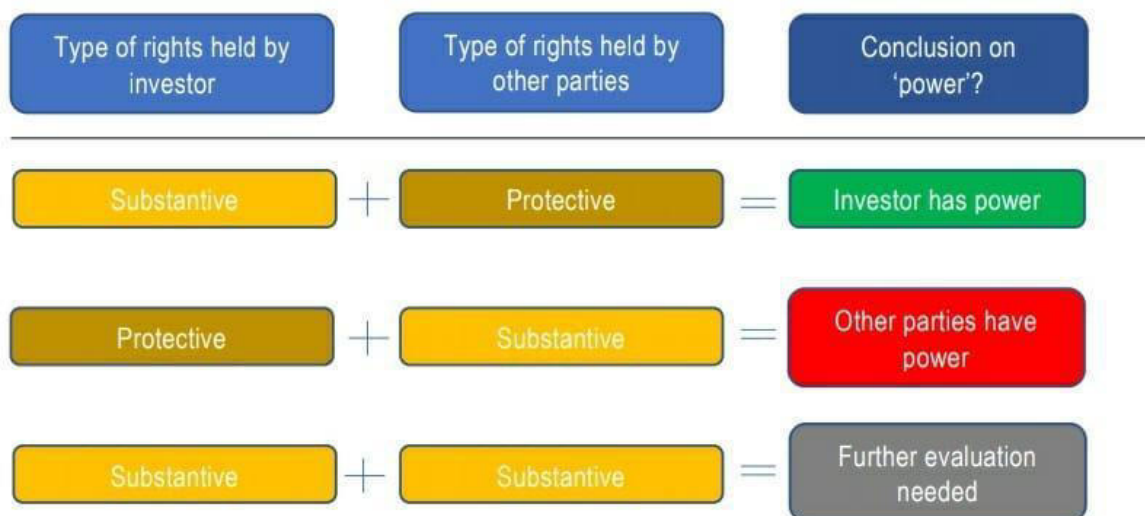
- Selling and purchasing of goods and services
- Managing financial assets
- Selecting, acquiring or disposing of Assets
- Taking Part in R&D of new products/processes
- Determining a funding structure or obtaining funding
- Taking operating and capital decisions
- Appointing, terminating Key Managerial Persons or Service providers.

Substantive Rights:

Ownership of more than fifty percent of the voting rights including potential voting rights, generally gives an investor the power. But this could be subject to regulatory restrictions, rights held by the other parties. Thus the voting rights sometimes may not be substantive.

Protective Rights:

- Protective rights are designed to protect the interests of their holders without giving that party power over the investee to which those rights relate.
- An investor that holds only protective rights cannot have power or prevent another party from having power over an investee.

**LINK BETWEEN POWER AND RETURNS**

- 1) An investor controls an investee if the investor not only has power over the investee and exposure or rights to variable returns from its involvement with the investee, but also has the ability to use its power to affect the investor's returns from its involvement with the investee.
- 2) Thus, an investor with decision-making rights shall determine whether it is a principal or an agent. An investor that is an agent does not control an investee when it exercises decision-making rights delegated to it.

FRANCHISES

- 1) In a franchise agreement, the investee i.e. the franchisee usually gives the franchisor the rights that are related to protecting the franchise brand.
- 2) Hence franchisor doesn't have ability to direct the relevant activities of franchisee and Franchisee operates the business on its own.

POWER THROUGH VOTING RIGHTS

- 1) In the most straightforward cases, the investor that holds a majority of voting rights has power over an investee.

- 2) However, there can be certain cases where an investor can have power even if it holds **less than a majority** of the voting rights of an investee.
- 3) Example of such situations are:
 - a) Contractual arrangements with other voting holders
 - b) Having Potential Voting Rights
 - c) Or Both

Example: (Potential Voting Rights)

Company P Ltd., a manufacturer of textile products, acquires 40,000 equity shares of Company X (a manufacturer of complementary products) out of 1,00,000 shares in issue. As part of the same agreement, Company P purchases an option to acquire an additional 25,000 shares. The option is exercisable at any time in the next 12 months. The exercise price includes a small premium to the market price at the transaction date.

After the above transaction, the shareholdings of Company X's two other original shareholders are 35,000 and 25,000. Each of these shareholders also has currently exercisable options to acquire 2,000 additional shares. Assess whether control is acquired by Company P.

Solution

In assessing whether it has obtained control over Company X, Company P should consider not only the 40,000 shares it owns but also its option to acquire another 25,000 shares (a so-called potential voting right). In this assessment, the specific terms and conditions of the option agreement and other factors are considered as follows:

- the options are currently exercisable and there are no other required conditions before such options can be exercised
- if exercised, these options would increase Company P's ownership to a controlling interest of over 50% before considering other shareholders' potential voting rights (65,000 shares out of a total of 1,25,000 shares)
- although other shareholders also have potential voting rights, if all options are exercised Company P will still own a majority (65,000 shares out of 1,29,000 shares)
- the premium included in the exercise price makes the options out-of-the-money. However, the fact that the premium is small, and the options could confer majority ownership indicates that the potential voting rights have economic substance.
- By considering all the above factors, Company P concludes that with the acquisition of the 40,000 shares together with the potential voting rights, it has obtained control of Company X.

EXPOSURE, OR RIGHTS, TO VARIABLE RETURNS FROM AN INVESTEE

- 1) Variable returns are returns that are not fixed and have the **potential to vary as a result of the performance of an investee**.
- 2) Variable returns can be positive or negative (Gains/losses).
- 3) Investor should have right to share in returns of investee.
- 4) Investor should be liable to bear the losses of investee.

Note: Exposure to variable returns is not in itself enough to conclude the assessment of control. An investor should have power over the investee and the ability to use its power to affect the amount of the investor's returns from its involvement with the investee. For example, it is common for a lender to have an exposure to variable returns from a borrower through interest payments that it receives

from the borrower, that are subject to credit risk. However, the lender would not control the borrower if it does not have the ability to affect those interest payments (which is frequently the case).

REPUTATIONAL RISK

- During the **financial crisis**, some banks helped out the investment projects they had started to avoid looking bad. For example, if a bank started a fund that was losing money, they might step in to help it out or even take charge of it to protect their own image.
- **Reputational risk is the chance that a company's image will be harmed** if one of their investments fails. For example, if a bank's investment loses money, it could make the bank look bad. To avoid this, the bank might help the failing investment, even if they're not legally required to do so.
- When deciding if a company controls an investment, **reputational risk is one thing to think about, but not the only thing**. For instance, a bank might be motivated to take control of a failing investment to protect their reputation, but just having this concern doesn't mean they have full control.

3. ACCOUNTING REQUIREMENTS OF INDAS 110

(A) Consolidation procedures

In order to prepare consolidated financial statements, INDAS 110 prescribes the following **consolidation procedures**:

1. **Combine** like items of assets, liabilities, equity, income, expenses and cash flows of the parent with those of its subsidiaries;
2. **Offset (eliminate)**:
 - The carrying amount of the parent's investment in each subsidiary; and
 - The parent's portion of equity of each subsidiary;
3. Eliminate in full **intra group** assets and liabilities, equity, income, expenses and cash flows relating to transactions between entities of the group.

(B) Other accounting requirements

Except for basic consolidation procedures, INDAS 110 prescribes number of other rules for preparing consolidated financial statements, such as:

- Presentation of **non-controlling interests**: in equity, but separately from the equity of owners of the parent;
- **Uniform accounting policies** shall be used by both parent and subsidiary;
- The financial statements of the parent and the subsidiary shall have the **same reporting date**;
- How to deal when the **parent loses its control** over subsidiary, and number of other rules dealing with the specific circumstances.

4. EXCEPTIONS IN INDAS 110

As we discussed above, when a parent controls a subsidiary, then it should consolidate.

But not always..... INDAS 110 sets the following **exceptions from consolidation**:

1. A PARENT DOES NOT NEED TO PRESENT CONSOLIDATED FINANCIAL STATEMENTS IF IT MEETS ALL OF THE FOLLOWING CONDITIONS:

- It is a **wholly-owned subsidiary** or is a **partially-owned subsidiary** of another entity and its other owners agree;
- Its debt or equity instruments are **not traded in a public market**;
- It **did not file, nor is it in the process of filing**, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market, and
- Its **ultimate or any intermediate parent** of the parent produces consolidated financial statements available for public use that comply with INDASs.

2. POST-EMPLOYMENT BENEFIT PLANS OR OTHER LONG-TERM EMPLOYEE BENEFIT PLANS to which supplies - they don't need to present consolidated financial statements.

3. INVESTMENT ENTITIES.

Investment entity is an entity that:

- a) **Obtains funds from one or more investors** for the purpose of providing those investor(s) with **investment management services**;
- b) Commits to its investor(s) that its **business purpose is to invest funds solely for returns** from capital appreciation, investment income, or both, and
- c) Measures and evaluates the performance of substantially all of its investments **on a fair value basis**.

5. INVESTMENT ENTITES

INDAS 110 sets the guidance and rules about determining whether the entity is an investment entity or not. **Typical characteristics of investment entities** are:

- It has more than one investment;
- It has more than one investor;
- It has investors that are not related parties of the entity;
- It has ownership interests in the form of equity or similar interests.

Note:

If an entity is providing "**Financial Support Services**" (providing loans and advances to others) for the purpose of making investment, then too such entity will be treated as Investment Entity.

EXIT STRATEGIES OF INVESTMENT ENTITY

One feature that differentiates an investment entity from other entities is that **an investment entity does not plan to hold its investments indefinitely**; it holds them for a limited period. Because equity

investments and non-financial asset investments have the potential to be held indefinitely, an investment entity shall have an exit strategy documenting how the entity plans to realize capital appreciation from substantially all of its equity investments and non-financial asset investments.

WHETHER ALL ASSETS TO BE MEASURED AT FAIR VALUE BY INVESTMENT ENTITY?

An investment entity may have some non-investment assets, such as head office property and related equipment, and may also have financial liabilities. The fair value measurement element of the definition of an investment entity applies to an investment entity's investments. Accordingly, an investment entity need not measure its non-investment assets or its liabilities at fair value.

CONSOLIDATION OF SUBSIDIARY OF INVESTMENT ENTITY IF SUCH SUBSIDIARY IS NOT INVESTMENT ENTITY

- If an investment entity has a subsidiary that is not itself an investment entity and whose main purpose and activities are providing services related to the investment entity's investment activities, it shall consolidate that subsidiary and apply the requirements of IndAS 103 to the acquisition of any such subsidiary.
- If the subsidiary that provides the investment-related services or activities is itself an investment entity then the investment entity parent shall measure that subsidiary at fair value through profit or loss.
- A parent of an investment entity shall consolidate all entities that it controls, including those controlled through an investment entity subsidiary, unless the parent itself is an investment entity.

6. CHANGE IN CLASSIFICATION of INVESTMENT ENTITY – Treatment in CFS

| When an Entity becomes an Investment Entity | When an Entity ceases to be an Investment Entity |
|--|---|
| <ul style="list-style-type: none"> • It is treated as Loss of Control on subsidiaries. • Derecognize the Net Assets, NCI of Subsidiary and related Goodwill/CR • Recognise the Investments at FVTPL as per Ind AS 109 • Note: any difference due to above adjustment is Gain/Loss - Transfer to Profit & Loss | <ul style="list-style-type: none"> • Start Consolidation from the date of change of status when it becomes non-investment entity • Date of Reclassification is treated as Deemed Acquisition Date • Net Assets, NCI and Goodwill/GBP shall be computed on the deemed acquisition date. |

- **Note:** Any cumulative balance in OCI shall be recycled to Profit & Loss.

7. REPORTING PERIOD OF PARENT AND SUBSIDIARY

1. The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements shall have the **same reporting date**.
2. When the end of the reporting period of the parent **is different from** that of a subsidiary (e.g. parent's financial year ends on 31 March 20X1 but the subsidiary's financial year ends on 31 December 20X0), the subsidiary prepares, for consolidation purposes, **additional financial information as of the same date** as the financial statements of the parent to enable the parent to consolidate the financial information of the subsidiary, **unless it is impracticable to do so**.
3. If it is impracticable to do so, the parent shall consolidate the financial information of the subsidiary using the **most recent financial statements** of the subsidiary adjusted for the **effects of significant transactions or events** that occur between the date of those financial statements and the date of the consolidated financial statements.
4. In any case, the difference between the date of the subsidiary's financial statements and that of the consolidated financial statements **shall be no more than three months**.

IMPORTANT SUMMARY POINTS REGARDING EXERCISE OF CONTROL

| | |
|--|---|
| Investor of Venture Capital Fund holding less than 50% | In case of Venture Capital Fund, if any investor (holding less than 50%) has right to take all decisions relating to investments/disinvestments to be done by such fund. Then it will be considered that such investor direct the relevant activities which can most significantly affect the returns of the Investee, even though such investor is not involved in day to day administration and appointment of members/committee. |
| There must be substantive rights to exercise control | Investor's right is treated as substantive only when there is No Barrier or restriction that prevents investor from exercising its right. If such restriction is involved then the rights are not substantive. |
| Stock Options with Investor | If Exercise price is lower than Market price then "Rights are Substantive" If Exercise Price is Higher than Market Price then "Rights are not substantive" |
| Right to Remove the Employee is substantive or not | If no substitute of particular employee is available, then right to remove that particular employee is not substantive . |

| | |
|--|--|
| Voting Rights are less than 50% | If voting rights are less than majority but are substantive to affect the relevant activities then it is treat that Investor has Power over investee |
| Major Holding with Single Person even though less than 50% | Any Person having absolute holding have power over investee if all other shareholders have small relative holdings |
| Dependency of Supply on Investor | If entity is dependent over Investor for material supply, then this can be an indicator that investor has Power over entity. |
| Holding Ordinary Shares and Potential Equity Shares | Actual voting rights (ordinary shares) added with potential voting rights together can provide controlling stake. |

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IND AS 111 – JOINT ARRANGEMENTS

1. WHAT IS THE OBJECTIVE OF INDAS 111?

Joint Arrangement: Agreement between two or more parties (Entities or Individuals) to exercise Joint Control over the Business.

Joint Control: following three conditions are satisfied to get Joint Control:

- (1) **Contractual Arrangement** between parties to share control;
- (2) **Sharing of Control:** Parties to the contract must agree to take decisions together (no single party can decide on its own);
- (3) **Unanimous Decisions:** every party of the joint arrangement must agree with (or at least does not object to) the decision and **no one can block it**.

IMPORTANT EXAMPLES FOR CLEAR UNDERSTANDING

Example 1: -

Rahul Ltd. & Rajat Ltd. agree through contract to share control over RR Ltd. in 50:50.

Answer - Joint Control Exist.

Example 2: -

Rahul Ltd. & Rajat Ltd. agree through contract to share control over RR Ltd. in 60:40.

Answer - Joint Control Exist.

Example 3: -

Rahul Ltd. 60% & Rajat Ltd. 40% started New Entity RR Ltd. (No Contract on such to Share Control)

Answer - Joint Control Does not Exist. (Therefore, No Joint Arrangement)

Rahul Ltd. is a Holding Company of RR Ltd.

RR Ltd. is a Subsidiary of Rahul Ltd.

Rajat Ltd is an investor with Significant influence over RR Ltd.

RR Ltd. is an Associate Company of Rajat Ltd.

Example 4: -

Rahul Ltd & Rajat Ltd. with 50:50 in Share Capital of RR Ltd. for Decision making minimum 51% Voting Right should be in Favor. Contract Exist.

Answer - Joint Control Exist

Example 5: -

Rahul Ltd./ Rajat Ltd./ Richa Ltd. with 33% each in Share Capital of RRR Ltd. Contract exist between all 3 to share Control.

Answer - Joint Control Exist

Example 6: -

Rahul Ltd. / Rajat Ltd. / Richa Ltd. with 33.33% in RRR Ltd. Contract between Rahul & Rajat only that for any Decision they will Share Control.

Decision requires minimum 75% Voting Right in Favor.

Answer - Joint Control Does not Exist, Since Richa can Block the Decision

Example 7: -

Rahul Ltd. / Rajat Ltd. / Richa Ltd. with 33.33% in RRR Ltd. Contract Between Rajul & Rajat only that for any Decision they will share control.

Decision required minimum 60% of Voting Rights in Favor.

Answer - Joint Control Exist

Richa Ltd. is not a Part of Contract - doesn't matter.

What Matter is Rahul Ltd. & Rajat Ltd. must take Unanimous Decision all time.

Example 8: -

Rahul Ltd. / Rajat Ltd. / Richa Ltd. with 33.33% each in RRR Ltd.

Decision requires Ordinary Resolution only.

Contract Exist. As per Past Experience Richa Ltd. Generally used to against in decision.

Answer - No Joint Control

No Unanimous decision are taken, Richa is Party to Contract, "there must be Unanimous Decision between Rahul / Rajat / Richa

Example 9: -

Rahul Ltd. (40%) & Rajat Ltd. (20%) & 40% Others (More than 20 Entities together) in RR Ltd.

Contract between Rahul & Rajat exist to Share Control Decision requires 51% at least.

Answer - Joint Control Exist

Example 10: -

Rahul (40%) / Rajat (20%) & 40% other (More than 20 Entities together)

Decision requires Ordinary resolution others (40%) are NRI & Never take part in Voting

Case 1 - Contract Exist between Rahul & Rajat.

Answer - Rahul & Rajat don't have good Bonding (Not taking Unanimous Decision)

No Joint Control

(Or)

Rahul / Rajat takes decision together always unanimously

Joint Control Exist

Case 2 - No Contract

Answer - Rahul is holding Company Considering Other 40% don't have any value.

Example 11: -

Rahul / Rajat / Richa with 33.33% each in RRR Ltd. All 3 have Contract to share control.

Decision requires minimum 60% Voting Rights in favor of Decision & Richa's Voting Right also must be required for any combination.

Answer - Joint Control Exist only when Rich becomes a part of Decision always, Only then it is treated as Unanimous Consent

2. TYPES OF JOINT ARRANGEMENT

There are 2 types of Joint Arrangements:

- **JOINT VENTURE:** In a **Joint Venture**, the parties having joint control have **Rights to the Net Assets** of the arrangement. These parties are called "Joint Venturers".

"Joint Venture is generally structured through a Separate Entity"

(Right to Net Assets means, All parties will get proportionate share of Net Assets of JV after paying all liabilities. No One will get Extra share in any Asset or Liability)

- **JOINT OPERATION:** In a **Joint Operation**, the parties having joint control have **Rights to the assets and obligations for the liabilities** relating to the arrangement. These parties are called "Joint Operators".

(Right to Assets & Obligation for Liabilities means, Each Party to the contract may have different share in All or Some Assets and Liabilities of Business. No One will get proportionate share in any Asset or Liability)

How to identify an arrangement is a JV or JO?

(a) NOT structured through a separate vehicle

When a joint arrangement is NOT structured through a separate vehicle, then the classification is easy: it is a **clear joint operation**.

(b) Structured through a separate vehicle

When the joint arrangement **is structured through separate vehicle**, then it can be **either joint venture or joint operation**.

| | |
|------------------------|---|
| Joint Venture | When the Assets and Liabilities held in a separate legal entity are the Assets/Liabilities of that Entity only and not the Assets/liabilities of the Parties. |
| Joint Operation | The parties are substantially the only source of cash flows contributing to the continuity of the operations of the arrangement. Hence, the arrangement depends on the parties on a continuous basis for settling the liabilities relating to the activity conducted through the arrangement. |

Example 12: Multiple joint arrangements under single framework agreement

AB Ltd. and CD Ltd. have entered into a framework agreement to manufacture and distribute a new product i.e. Product X. The two activities to be performed as per the framework agreement are

- i) Manufacture of Product X and
- ii) Distribution of Product X.

The manufacturing of the product will not be done through a separate vehicle. The parties will purchase the necessary machinery in their joint name.

For the distribution of the product, the parties have established a new entity ABCD Ltd. All the goods manufactured will be sold to ABCD Ltd. as per price mutually agreed by the parties. Then ABCD Ltd. will do the marketing and distribution of the product. Both the parties will have joint control over ABCD Ltd.

The legal form of ABCD Ltd. causes it to be considered in its own right (ie the assets and liabilities held in ABCD Ltd. are the assets and liabilities of ABCD Ltd. and not the assets and liabilities of the parties). Further, the contractual arrangement and other relevant facts and circumstances also do not indicate otherwise.

Determine whether various arrangements under the framework agreement are joint operation or joint venture?

Solution:

The manufacturing of Product X is not done through a separate vehicle and the assets used to manufacture the product are jointly owned by both the parties. Hence, the manufacturing activity is a joint operation.

The distribution of Product X is done through a separate vehicle i.e. ABCD Ltd. Further, AB Ltd. and CD Ltd. do not have rights to the assets, and obligations for the liabilities, relating to ABCD Ltd. Hence ABCD Ltd. is a joint venture.

3. ACCOUNTING FOR JOINT ARRANGEMENTS

IND AS 111 sets two different methods of accounting for interests in joint arrangements, depending on the type of the arrangement:

3.1 ACCOUNTING FOR INTEREST IN JOINT VENTURE

a) In Consolidated Financial Statements of Investor

Investor (Joint Venturer) shall apply Ind AS 28 "Equity Method to its Investment in Joint Venture, unless the Investor entity is exempted from applying the equity method as specified in that standard.

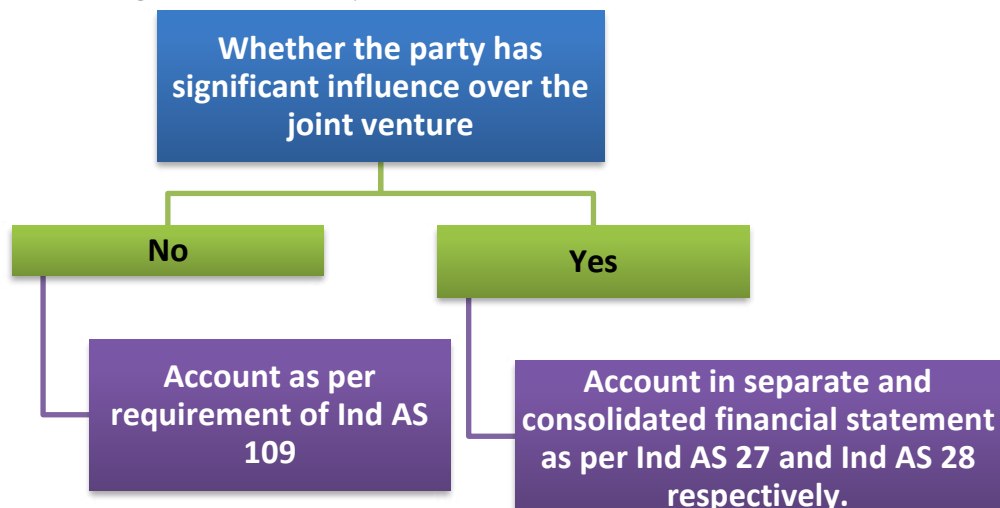
b) In the Separate financial statements of Investor

Investor (Joint Venturer) shall apply Ind AS 27 to its Investment in Joint Venture. As per Ind AS 27, two options are available:

- (i) Cost Model
- (ii) Fair Value Model

c) Accounting by an entity that is a party to the joint venture but does not have joint control:

A party that participates in, but does not have joint control of, a joint venture shall also account for its interest in the arrangement in its separate and consolidated financial statements as follows:

**3.2 ACCOUNTING FOR INTEREST IN JOINT OPERATION**

When an investor classifies its investment as a joint operation, then it should apply "Proportionate Consolidation Method" and recognize its share of Assets, Liabilities, Incomes and Expenses of Joint Operation in its Separate Financial Statement.

Proportionate Consolidation Method:

- 1) Investor (Joint Operator) shall recognise **its own share in the Fair Value of Net Assets** of Joint Operation (including Deferred Tax Impact).
- 2) **NCI shall not be recognised.**
- 3) Recognise Acquisition Related Cost as an **Expense in P&L.**
- 4) Excess of PC over Share of Net Assets will be **Goodwill or Gain from Bargain Purchase.**

Example 13: (On Proportionate Consolidation Method)

Rajat Ltd & Rahul Ltd. entered into a Joint Arrangement by Creating Partnership Firm M/s RR Sharing 50:50.

Balance Sheet of M/S RR as on 31/3/24

| | | | |
|--------------------|--------------------|-------------------|--------------------|
| Rajat Ltd. Capital | 48,00,000 | Land | 30,00,000 |
| Rahul Ltd. Capital | 52,00,000 | Land & Building | 35,00,000 |
| P & L A/c | 10,00,000 | Plant & Machinery | 40,00,000 |
| Loan 1 | 15,00,000 | Other Assets | 45,00,000 |
| Loan 2 | 8,00,000 | | |
| Other Liabilities | 17,00,000 | | |
| | 1,50,00,000 | | 1,50,00,000 |

- Rahul Ltd. has full right on Land & Full Obligation of Loan 2.
- Rajat Ltd & Rahul Ltd. has 50:50 in all others.
- M/S RR was Formed in 1/4/23 i.e., DOA with initial capital of 48,00,000/- by Rajat and 52,00,000/- Rahul

- FV of L&B on 1/4/23 was 40,00,000/-
- FV of P&M on 1/4/23 was 45,00,000/-

Describe Accounting treatment for Rahul Ltd.

Solution

- 1) M/S RR is a Joint Operation
- 2) M/S RR is running a Business
- 3) Rahul Ltd. shall apply Proportionate Consolidation method in its CFS.
- 4) Rahul Ltd. Shall apply Proportionate Consolidation Method in its CFS.
- 5) Cost of Control:

| | | |
|--------------------------------------|------------|------------------|
| Investment in M/S RR | | 52,00,000 |
| (-) 50% Share in FV of Net Assets | | (71,00,000) |
| Full Land | 30,00,000 | |
| Share in L&B | 20,00,000 | |
| Share in P&M | 22,50,000 | |
| Share in Other Assets | 22,50,000 | |
| (-) Loan 2 | (8,00,000) | |
| (-) Share in Loan 1 | (7,50,000) | |
| (-) Share in other Liabilities | (8,50,000) | |
| Gain on Bargain Purchase (CR) | | 19,00,000 |

- 6) Rahul Ltd. shall prepare CFS & Show its Share of Assets/Liabilities in M/S RR along with GBP

4. TRANSACTIONS BETWEEN JOINT OPERATION & ITS OPERATORS

Transactions between Joint Venture and Joint Operators

- Sale of Asset by Operator to Joint Operation:

Recognise gains and losses resulting from such transactions **only to the extent of the other parties' interest** in the joint operation.

Cash/Bank A/c Dr. (Sale Value x Share of Other Parties)

Share in JO Asset A/c Dr. (BV x Own Share)

Loss on Sale A/c Dr. (B/f)

To Asset A/c (Book Value of Asset)

To Gain on Sale A/c (B/f)

- Purchase of Asset by Operator from Joint Operation:

Operator **shall not recognize its share** of the gains and losses until it resells those assets to a third party.

Asset A/c Dr. (Total Transaction Value - Own Share of Profit earned)

To Share in JO Asset (BV x Own Share)

To Cash/Bank A/c (Sale Value x Own Share)

Transaction Between JO & Parties in JO

Example 14: -

Rajat Ltd. & Rahul Ltd. (50:50) in Joint Operation RR Ltd.

Rajat Ltd. sold its PPE to JO whose CA is 90 lakhs & sold @100 lakhs

Solution:

1) Books of Rahul Ltd.

| | | | |
|------------------|------------------|-----------|-----------|
| Share in PPE A/c | Dr. | 50,00,000 | |
| | To Rajat Ltd A/c | | 50,00,000 |

2) Books of Rajat Ltd.

| | | | |
|---------------------|-------------------|-----------|-----------|
| Rahul Ltd. A/c | Dr. | 50,00,000 | |
| Share in Assets A/c | Dr. | 45,00,000 | |
| | To Asset A/c | | 90,00,000 |
| | To Gain (B/F) A/c | | 5,00,000 |

Conclusion:

Operators/Parties shall not record their own share of Profit/Loss

However, own shares of Loss may be recorded if there is permanent decline in value of Asset/Inventory.

Example 15: -

Rajat Ltd. & Rahul Ltd. (50:50) in joint Operation RR Ltd.

RR Ltd. sold Assets to Rahul Ltd. total cost 90 sold at 100

Solution:

Books of Rajat

| | | | |
|------------------|-----------------------|----|----|
| Bank / Rahul A/c | Dr. | 50 | |
| | To Share in Asset A/c | | 45 |
| | To Bank / Rajat A/c | | 5 |

Books of Rahul

| | | | |
|------------|-----------------------|----|----|
| Assets A/c | Dr. | 95 | |
| | To Share in Asset A/c | | 45 |
| | To Bank / Rajat A/c | | 50 |

IMPORTANT SUMMARY POINTS TO IDENTIFY JOINT ARRANGEMENT

- 1) If any **single party cannot make decisions** about relevant activities of the entity, then they are supposed to have joint arrangement to control the entity.
- 2) When an **investor has the right to appoint chairman** of the board who will have right of a casting vote in case of deadlock situation, then such investor will be have power over the investee and this is not joint control.
- 3) When all assets are purchased, and liabilities are incurred **in the name of Joint Arrangement** then such arrangement is considered to be a Joint venture.
- 4) A **Partnership firm** created under Joint Arrangement; it is **not a Joint Venture**. It is Joint Operation.

- 5) When a question doesn't mention any thing about separate vehicle (there is no discussion on separate legal entity) then we shall always assume that the Arrangement is not structured through Separate legal entity and it will be considered as Joint Operation.

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IND AS 28 – INVESTMENT IN ASSOCIATES & JV

1. This Standard is applicable to Investment in Associate and Joint Venture both.
2. This standard prescribes "Equity method accounting" for measurement of Investment in Associates & Subsidiary in CFS.

1. IMPORTANT DEFINITIONS

| | |
|--------------------------------|--|
| Associate Company | If an Investor acquires 20% or more but upto 50% of the equity shares of Investee, then such Investee company is known as Associate Company. In such situation, investor gets significant influence over the Investee. Sometimes, having less than 20% equity investment also creates significant influence if it is clearly demonstrated . |
| Significant Influence | Investors have Power to Participate in the financial and operating policy decisions of the Investee but cannot exercise Control. |
| Potential Voting Rights | Share Warrants, Call Options, Convertible Instruments. These potential voting rights can give additional voting power to the investor if they are currently exercisable. |

Financial Statements of Investor who has Investment in Associate and JV

1. **Standalone Financial Statement (SFS):** Investor Shall apply Ind AS 27 to the Investment in Associate and JV. (i.e. Cost Model or Fair Value Model)
2. **Consolidated Financial Statement (CFS):** Investor shall apply Equity Method to the Investments in Associate and JV as per Ind AS 28

2. EQUITY METHOD

Equity means Net Assets. Therefore, Equity Method means Measuring Investments in Proportion to Fair Value of Net Assets of Investee (Associates / JV).

Following Steps should be applied in Equity method:

Step 1: On the Date of Acquisition, calculate Goodwill or Gain from Bargain Purchase as under:

| | |
|---|---|
| Consideration Paid to Acquire Investment (-) Investor's Share in Fair Value of Net Assets of Associate/JV | XXX (XXX) |
| If Positive - it is Goodwill It is already included in Carrying Amount of Investment and should not be recognised separately | XXXX (No Separate Entry) |
| If Negative - it is Gain from Bargain Purchase It should be recognised as Capital Reserve, it represents that Carrying Value of Investments are Lower than the Share in FV of Net Assets hence Investment Value is increased. | XXXX Investment A/c Dr. To Capital Res. |

Step 2: Recognise Post Acquisition Changes in Net Assets of Associate/JV by Increasing or decreasing the value of Investments.

Post Acquisition changes means Profits/Loss earned by Investee, OCI of Investee, Dividend declared and paid by investee, Depreciation adjustment due to Fair Value Impact on DOA, Unrealized gains on Inter company transactions and Impairment losses of Investee.

| Value of Investment shall be increased or decreased by- | Rs. | Journal Entry |
|---|------|--|
| Cost of Investments (Including Goodwill if any) | xxxx | - |
| (+) Capital Reserve as on DOA | xxxx | Investment A/c Dr. To Capital Res. |
| (+/-): Post acquisition share in P&L of Associate/JV (EAESH) | xxx | Investment A/c Dr. To Cons. P&L A/c Cons. P&L A/c Dr. To Investment A/c |
| (+/-): Post acquisition share in OCI of Associate/JV | xxx | Investment A/c Dr. To Cons. OCI A/c Cons. OCI A/c Dr. To Investment A/c |
| (-): Share of Dividend Received from Associate/JV | xxx | Bank A/c Dr. |

| | | |
|--|-------------|--|
| | | To Investment A/c |
| (-): Additional depreciation or Saving in Depreciation on revaluation profit of PPE (if any) | xxx | Investment A/c Dr. To Cons. P&L A/c |
| | | Cons. P&L A/c Dr. To Investment A/c |
| (-): Unrealised profit on downstream transaction to the extent of Investor's share in gain/loss of Associate/JV | xxx | Cons. P&L A/c Dr. To Investment A/c |
| (-): Share of Impairment loss if any | xxx | Cons. P&L A/c Dr. To Investment A/c |
| Value of Investments as on Balance Date | xxxx | |

Example 1: -

On 1/4/24, B Ltd. acquired 20% Equity interest in A Ltd. at a cost of 2,40,000/-

FV of Net Assets of B Ltd. on 1/4/24 is 10,00,000/-

Apply Equity Method on DOA.

Solution:

| | |
|---|---------------|
| Cost of Investment @ 20% | 2,40,000 |
| (-) Proportionate Value of Net Assets @ 20% | 2,00,000 |
| Goodwill | 40,000 |

SFS of B Ltd. as on 1/4/24 (INDAS 27)

| | |
|------------------|----------|
| Investment @ 20% | 2,40,000 |
|------------------|----------|

CFS of B Ltd. as on 1/4/24 (INDAS 28)

| | |
|--|----------|
| Investment @ 20% (Including Goodwill 40,000) | 2,40,000 |
|--|----------|

As per INDAS 28, Goodwill is not required to be recognized separately, it is just a part of Investment Cost.

Example 2: -

Same as Example 1, But FV of Net Assets on DOA is 15,00,000

Solution:

| | |
|---|---------------|
| Cost of Investment @ 20% | 2,40,000 |
| (-) Proportionate Value of Net Assets @ 20% | 3,00,000 |
| | 60,000 |

Investment are unvalued, We have to record 60,000 to make it @3,00,000

| | | |
|--------------------|--------|--------|
| Investment A/c Dr. | 60,000 | |
| To CR | | 60,000 |

CFS of B Ltd. as on 1/4/24 (INDAS 28)

| | |
|-------------------------|----------|
| Investment @ 20% | 3,00,000 |
| Reserves & Surplus : CR | 60,000 |

Example 3: -

On 1/4/24, B Ltd acquired 20% Equity Interest in A Ltd. at a cost of 2,40,000/-

On 1/4/24, Equity share Capital of A Ltd. was 8,00,000/- and Reserves & Surplus was 3,00,000

On 31/3/25 Reserves & Surplus of A Ltd was 5,00,000

Apply INDAS 28 on DOA & Balance Sheet Date

Solution:**Equity Method (INDAS 28)**

| | |
|---|----------|
| Investment Cost as on DOA (Including Goodwill 20,000) | 2,40,000 |
| + 20% Share in Post-Acquisition Profits of Associate (2,00,000 x 20%) | 40,000 |
| Investment 31/3 | 2,80,000 |

31/3 Journal Entry

| | | |
|-------------------------|-----|--------|
| Investment A/c | Dr. | 40,000 |
| To Consolidated P&L A/c | | 40,000 |

Consolidated Balance Sheet

| | |
|---------------------------------------|----------|
| Investment @ 20% (Including Goodwill) | 2,80,000 |
| Other Equity : Consolidated P&L | 40,000 |

Example 4: -

On 1/4/24 B Ltd. acquired 20% Equity interest in A Ltd. at a cost of 2,40,000/-

On 1/4/24 Equity Share Capital of A Ltd was 8,00,000 and Reserves & Surplus of A Ltd. was 3,00,000

On 31/3/25 Reserves & Surplus of A Ltd. was 5,00,000

During 24-25 Dividend Paid by A Ltd. to its Share Holders 15%

Apply INDAS 28 on DOA & Balance Sheet Date.

Solution:**Analysis of Profit of A Ltd.**

| | DOA | Post - Acquisition | Balance Sheet |
|--------------------|-----------------|--------------------|---------------|
| Reserves & Surplus | 3,00,000 | 2,00,000 | 5,00,000 |
| + Dividend | - | 1,20,000 | |
| | 3,00,000 | 3,20,000 | |

3,20,000 is the Total Earning of A Ltd. for the year

Post-Acquisition share in Profit (20%) = 64,000

Equity Method

| | |
|---|----------|
| Investment Cost as on DOA (Including Goodwill 20,000) | 2,40,000 |
| +20% share in Post - Acquisition Profit @ 20% | 64,000 |
| (-) Dividend Received | (24,000) |
| Investment @ 20% as per Equity | 2,80,000 |

1/4/24 - Investment Purchased

| | | | |
|----------------|-------------|----------|----------|
| Investment A/c | Dr. | 2,40,000 | |
| | To Bank A/c | | 2,40,000 |

31/3/25 - Consolidation

| | | | |
|----------------|---------------------|--------|--------|
| Investment A/c | Dr. | 64,000 | |
| | To Consolidated P&L | | 64,000 |

During 24-25 - Dividend Received

| | | | |
|----------|-------------------|--------|--------|
| Bank A/c | Dr. | 24,000 | |
| | To Investment A/c | | 24,000 |

(This is not Income. This is Recovery)

Example 5: -

Date of Acquisition is 1/4/24

B Ltd. has Invested in 30% Equity of A Ltd. @4,50,000/-

Equity Share Capital of A Ltd. is 10,00,000

Reserves & Surplus of A Ltd. as on DOA is 6,00,000/-

Post-Acquisition Profits are as under: -

Before Dividend:

P & L is 3,00,000 and OCI Gain is 50,000

Dividend Paid by A is 1,00,000

Solution:

| | |
|---|-----------------|
| Investment Cost as on DOA | 4,50,000 |
| + CR as on DOA | 30,000 |
| Investment as on DOA | 4,80,000 |
| + Share in Post - Acquisition Profit: | |
| P & L | 90,000 |
| OCI | 15,000 |
| (-) Dividend Received | (30,000) |
| Investment as on 31/3/25 (Equity Method) | 5,55,000 |

1/4/24 - CFS

| | | | |
|----------------|-----------|--------|--------|
| Investment A/c | Dr. | 30,000 | |
| | To CR A/c | | 30,000 |

During the Year - Dividend

| | | | |
|----------|-------------------|--------|--------|
| Bank A/c | Dr. | 30,000 | |
| | To Investment A/c | | 30,000 |

31/3/25

| | | | |
|----------------|-----|----------|--|
| Investment A/c | Dr. | 1,05,000 | |
|----------------|-----|----------|--|

| | |
|-------------------------|--------|
| To Consolidated P&L A/c | 90,000 |
| To Consolidated OCI A/c | 15,000 |

UPSTREAM TRANSACTIONS BETWEEN THE INVESTOR AND ITS ASSOCIATE/JV

'Upstream' transactions are, for example, sales of goods by associate or joint venture to the investor. Investor shall eliminate the profit element from unsold portion of inventory held as on balance sheet date:

Consolidated P&L A/c Dr.
To Inventory A/c

Example 6:

B Ltd. (Investor) has 30% Investment in A Ltd. (Associate)

A Ltd. has sold goods costing Rs. 1,00,000 to B Ltd. @Rs. 1,50,000.

All goods are Unsold at year end.

How to eliminate Unrealised Profit?

Solution:

Associate has sold goods to Investor so this is an Upstream Transaction

A Ltd. must have recognised profit on sale of Rs. 50,000 in its P&L.

Therefore, Investor's Share in above Profit is Rs. 15,000 (30% of Rs. 50,000) & through equity method this must have been a part of Investment A/c and P&L A/c of B Ltd.

| | | | |
|---------------------------|-----|--------|--------|
| Investment A/c | Dr. | 15,000 | |
| To Consolidated P & L A/c | | | 15,000 |

Now, Investor B Ltd. has unsold Inventory of Rs. 1,50,000 Which includes Rs. 15,000 Profit Shares of Investor (B Ltd.)

Therefore, 15,000 Profit shall be eliminated as under:

| | | | |
|------------------------|-----|--------|--------|
| Consolidated P & L A/c | Dr. | 15,000 | |
| To Inventory A/c | | | 15,000 |

Example 7:

In Above Example assume B Ltd. (Investor) has Sold goods to A Ltd. (Associate)

Solution:

Downstream Transaction

- 1) Full 50,000 earned by Investor (B Ltd.) from sale of goods.
- 2) Unsold Inventory lying at Associate at 1,50,000/-

Since Inventory is a part of Net Assets of Associates, we can conclude that Net Assets of Associate Company includes Unrealised profit of 50,000/- Equity Method - Means Proportionate Share of Net Assets of Associates Therefore, when we have applied equity method. Investment must be shown in Proportion of Net Assets i.e., 30% of Net Assets

Which means Investment Value must include 15,000 Unrealised Profit which is to be eliminated.

Consolidated P&L A/c Dr. 15,000
To Investment A/c 15,000

3. TYPES OF INVESTMENT IN ASSOCIATE/JV & LOSS-MAKING

ASSOCIATE/JV

1) Investor's investment in Associate/JV may consist of following items:

- (i) Investment in Equity Shares of Associate and JV.
- (ii) Investment in Preference shares and Long-Term Debt Instruments of Associates and JV (Also called other components of Investments).

These investments will be considered as a part of permanent funding just like equity investments **if their repayment is not scheduled and fixed.** (it means they are as good as Equity Investments)

2) Associate/JV earned Profit during the year:

The investor shall recognise its own share of profit in Investment in Equity A/c.

3) Associate/JV incurred Losses during the year:

- a) Investor's share of loss in Associate/JV shall be allocated to Investment in Equity a/c (as per Equity method) only to the extent of carrying value of Investment in Equity share A/c
- b) Any Remaining loss (i.e. unrecognized loss) should be allocated or applied to other components of investments in the following order:
 - First, Investment in Preference Shares of Associate/JV
 - Then, Investment in long term loans/debentures of Associate/JV
- c) However, above loss shall be applied to those other components only after applying Ind AS 109 on such investments.
- d) After setting off the share in loss in above investments, if any unrecognized loss still remains (i.e. all Investments are reduced to zero) then such loss may be provided as liability only when investor has any legal or constructive obligation to make the loss good.

Consolidated P&L A/c Dr.
To Liability A/c

Note: Ignore above entry if there is no obligation.

- e) Un-recognised loss (for which no liability is provided) can be carried forward to the next year for writing off against value of investments if they are positive after applying Ind AS 109 at fair value.
- f) When Associate/JV subsequently generates profits, such profits shall be allocated in the following order:
 - 1st Priority - Investment in Long Term Loans/Debentures of Associate/JV
 - 2nd Priority - Investment in Preference Shares of Associate/JV
 - 3rd Priority - Investment in Equity Shares of Associate/JV.

4. DISCONTINUING THE USE OF EQUITY METHOD

An entity shall discontinue the use of the equity method from the date when its investment ceases to be an associate or a joint venture.

Situation 1: Acquired Further Equity Interest and Investment becomes a subsidiary

- If the investment becomes a subsidiary, the entity shall account for its investment in accordance with Ind AS 103 and Ind AS 110.
- Follow Step Acquisition guidance already discussed in Ind AS 103 i.e. Recognise gain/loss due to fair value adjustment of previous investment.

Situation 2: Sold Part of the Investment and Retained interest in the former Associate or Joint Venture is a financial asset

Retained interest in the former associate or joint venture that is a financial asset shall be measured at fair value. Following Journal Entry is required:

| | |
|---|-------------------------------------|
| Bank A/c Dr. | (Sale Proceeds) |
| Investment A/c Dr. | (Retained Investment at Fair Value) |
| To Investment in Associate/JV A/c | (Carrying Amount) |
| (Difference is transfer to Profit and Loss A/c of Investor) | |

Impact on OCI Share due to Discontinuance of Equity Method:

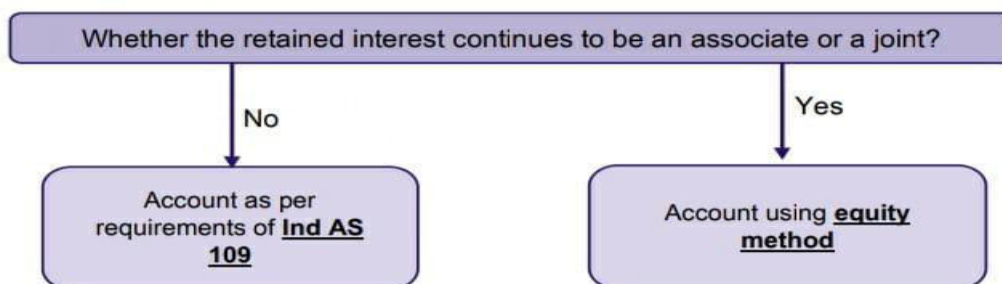
- On discontinuation of equity method, any share in the other comprehensive income of associate or joint venture that was previously recognized by the entity shall be reclassified to profit or loss of investor if allowed to be reclassified.
- Those OCI Balances which are not allowed to be reclassified such as Revaluation Surplus shall be re-classified directly to retained earnings (not in Profit and Loss, as it is not allowed to be re-classified to P&L as per IndAS 16)

Example 8:

An investor has recognised in past in its other comprehensive income its share of Rs. 10,000 in the cumulative exchange differences relating to a foreign operation of its associate. Now, the investment in that associate is sold and equity method of accounting is stopped. So, the investor shall reclassify the cumulative exchange differences of Rs. 10,000 recorded in its other comprehensive income to profit or loss.

5. CLASSIFICATION OF INVESTMENT IN ASSOCIATE OR JV AS HELD FOR SALE

- An entity shall apply Ind AS 105 'Non-current Assets Held for Sale and Discontinued Operations' to an investment, or a portion of an investment, in an associate or a joint venture that meets the criteria to be classified as held for sale.
- Any **retained portion of an investment** in an associate or a joint venture that has not been classified as held for sale shall be accounted as follows:
 - Till the time disposal of the portion that is classified as held for sale takes place:
Accounted using equity method
 - After the disposal of the portion that is classified as held for sale takes place
Accounted as follows:



6. EXEMPTIONS FROM APPLYING THE EQUITY METHOD

An entity need not apply the equity method to its investment in an associate or a joint venture in following cases:

1. **An Investor does not need to Equity Method if it meets all of the following conditions:**
 - It is a **wholly-owned subsidiary** or is a **partially-owned subsidiary** of another entity and **the owners of the entity are informed and they do not object** to the entity not applying the equity method.
 - Its debt or equity instruments are **not traded in a public market**;
 - It **did not file, nor is it in the process of filing**, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market, and
 - Its **ultimate or any intermediate parent** produces consolidated financial statements available for public use that comply with INDASs.
2. **Investment Entities:** are not required to follow Equity Method

7. OTHER IMPORTANT POINTS

- 1) Investor shall consider direct and indirect holding while applying Equity Method.

Example 9:

A Ltd., its subsidiary B Ltd. and its joint venture C Ltd. holds 15%, 10% and 10% respectively of the share capital of an associate X Ltd. Hence, to apply equity method, A Ltd. shall consider the interest held by it and by its subsidiary B Ltd. i.e. total interest of 25%. It shall not consider the interest held by C Ltd. which is a joint venture.

- 2) When an associate or a joint venture has subsidiaries, associates or joint ventures then consider Consolidated Earnings of Associate/JV while applying Equity Method.

Example 10:

X Ltd. has an associate, P Ltd. P Ltd. has further invested in a subsidiary Q Ltd. and a joint venture R Ltd. Hence, for the purpose of applying the equity method, X Ltd. shall consider the consolidated financial statements of P Ltd.

Example 11:

B Ltd. has Invested in 25% of Equity of A Ltd (Associate)

A Ltd. has 80% Equity Investment in C Ltd. (Subsidiary)

Cost of Investment for B is 1,00,000

Net Assets of A Ltd. as on DOA is 4,00,000 (ESC - 3,00,000 and R&S - 1,00,000)

During the Year A Ltd. Earned 50,000 & C Ltd. Earned 40,000

Apply Equity Method.

Solution:

| | |
|---------------------------|----------|
| Investment | 1,00,000 |
| + Post Acquisition Profit | |
| 50,000 × 25% | 12,500 |
| 40,000 × 80% × 25% | 8,000 |
| | 1,20,500 |

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IND AS 115 – REVENUE FROM CONTRACTS WITH CUSTOMERS

1. OBJECTIVE OF IND AS 115

In this standard, we will discuss about:

- Nature of Revenue.
- How to find out the Amount of Revenue
- When to recognise the Revenue
- What to do when there is uncertainty of collection
- How to Recognise the Cost of earning Revenue.

2. WHO IS CUSTOMER?

- A customer is a party that has contracted with an entity:
 - to obtain goods or services
 - such goods & services are an output of the entity's ordinary activities
 - in exchange for consideration.
- If you have a contract with a party other than a customer, then IND AS 115 does not apply.

Examples:

Gifts are distributed by Pharma company to doctors as a part of its sales promotion activities so that doctors promote their medicines.

Here, the doctors are not 'customers' of pharma company.

The items distributed as gifts are not an output of Pharma company's ordinary activities.

Pharma company should recognise gift distribution as on expense in P&L A/c.

3. NON - APPLICABILITY

There are some exclusions from IND AS 115, namely: (L.I.F.E)

- Leases within the scope of IND AS 116;
- Insurance contracts (IND AS 104);
- Financial instruments (Ind AS 27, 28, 32, 109, 27, 103, 110, 111)
- Non-monetary Exchanges between entities within the same business to facilitate sales.
(For example, a contract between two oil companies that agree to an exchange of oil to fulfill demand from their customers in different specified locations on a timely basis).

4. FIVE STEPS TO RECOGNIZE REVENUE UNDER IND AS 115 (C. P. T.– A. R.)

Core Principle of Ind AS 115:

An Entity should record the revenue at the amount **it expects to receive in exchange for the goods and services** delivered to the customer.

There are many situations which are not straight forward and entities recognize revenues differently in these cases, for example:

- Buy 1 + Get 1 free.
- Buy monthly prepaid plan + get handset for free.
- Earn loyalty points and cash them out/receive free goods later on.
- Get bonuses for delivery on time; etc.

To make it systematic, IND AS 115 requires application of **5 step model for revenue recognition**.

Step - 1

- Identify the **contract** with a customer

Step - 2

- Identify the **performance obligations (PO)** in the contract

Step - 3

- Determine the **transaction price (TP)**

Step - 4

- **Allocate** the TP to the PO in the contract

Step - 5

- **Recognize revenue** when (or as) an entity satisfies a PO

5. STEP - 1 IDENTIFY THE CONTRACT WITH THE CUSTOMER

- There should be a contract between entity and customer.
- Contract can be oral or written or implied, but it should be enforceable by law.
- A Contract must have following 5 characteristics to fulfill the step 1:

(A . R . C . T . C)

1. Parties to the contract has **approved** it and are **committed to** perform;

This means both the parties have agreed to the terms and conditions of the contract.

2. Each party's **Rights** to the goods/services transferred are **identified**;

The contract should not be one-sided i.e. in favour of either party. Both entity's and customer's rights are identified in the contract. Such as in event of default by entity customer can deduct the amount and vice versa.

3. The contract has a **Commercial Substance (i.e. Profit Motive)**

INTRA GROUP TRANSACTIONS will not be considered under the contract.

4. The payment **Terms** are **identified**.

How the payment will be made (online mode, in Cash or in Kind)?

How much amount the customer will pay?

When the Payment is to be made? (Timing)

5. It is **probable** that an entity will **Collect the consideration**. Here, the entity should check the customer's **ability and intention** to pay.

Treatment of the consideration received from the customer in a contract where all the above conditions are not fulfilled:

| General Rule | Exceptions |
|--|--|
| <p>Do Not Recognise revenue until the conditions are fulfilled. Treat such consideration as Liability (Advance collected from customer)</p> | <p>Recognise revenue in following cases: Case 1: if substantial goods and services are transferred and substantial amount of consideration is collected. (or) Case 2: Contract is terminated, and amount received is not refundable.</p> |

CONTRACT COMBINATION

Two or more contracts with **same customer** (& near the same time) shall be combined to make **a single contract** if **any one** of the following conditions are satisfied:

- 1) The contracts are negotiated as a **single package**.
- 2) The amount of consideration paid in one contract **depends on the price or performance in the other contract**: or
- 3) The goods or services promised in all the contracts are **a single performance obligation (i.e. part of single commercial objective)**.

CONTRACT MODIFICATION:

Contract modification is the **change in the scope of the contract** such as price change, additional goods or services are introduced, existing goods or services are reduced.

Accounting for Contract Modification:

| Situation 1 | Situation 2 | Situation 3 |
|---|---|---|
| <p>Distinct Goods & Services are added (Nature of Additional goods and services are different from goods & services of original contract) and Price of additional goods and</p> | <p>Remaining Goods & Services are Distinct (different nature) from the goods & services transferred before modification. and Price is Not Standalone</p> | <p>Remaining Goods & Services are not Distinct. There is either addition or reduction of same goods & services. (or) There is an change in price of remaining goods & services to</p> |

| | | |
|---|--|---|
| <p>services are Stand alone selling price (price is not affected due to original contract)</p> | <p>Selling Price (Price is affected due to original contract)</p> | <p>be supplied.</p> |
| <p>Treat this as a separate contract and not a modification.</p> | <ul style="list-style-type: none"> • Terminate the original contract. • Do not adjust already recognised revenue. • Create New Contract for remaining goods & services to be delivered. • Allocate the remaining Transaction Price to the remaining Goods & Services to be transferred | <p>Accounting Treatment: Cumulative Catchup Adjutement (also called retrospective adjustment)</p> <p>Adjust already recognised revenue retrospectively with new changes.</p> |
| <p>Example: A company agrees to sell 120 Android Phones for ₹10,000 each. After delivering 60 phone, the contract is modified to add 30 iPhones for ₹15,000 each, which is the standalone price. Since the additional 30 iPhones are distinct and priced separately, the contract modification is treated as a new contract. The new contract is for 30 iPhones at ₹15,000 each (₹4,50,000 in total), and this doesn't affect the accounting for the initial 120 Android Phones.</p> | <p>Example: A company sells products and provides maintenance services. After delivering half of the products, the customer requests additional products at a lower price. If these additional products are distinct, the old contract is terminated, and a new contract is created for the remaining goods and services.</p> | <p>Example: A construction company agrees to build a bridge, and after part of the work is completed, the contract is modified to include additional features. Since the work is not distinct, the modification is accounted for using a cumulative adjustment.</p> <p>Example: A company signs a contract to provide 200 hours of labor at ₹150 per hour, totaling ₹30,000. After completing 100 hours, the contract is modified to add 50 more hours at ₹100 per hour. The total contract now includes 250 hours at an average rate of ₹140 per hour. (35000 ÷ 250 hrs)</p> |

6. STEP - 2

IDENTIFY THE PERFORMANCE OBLIGATIONS

Performance Obligation means **Promise to transfer**:

| | | |
|---|--|---|
| Promise to transfer "Single Goods & Services" | Example: a) Transfer of Machine b) Providing Consultancy Service | Recognise the revenue when control over goods or services are transferred. |
| Promise to transfer "Bundle of distinct goods & services" | Example: Sale of Car along with 3 Free After Sale services | Recognise the Revenue for each distinct goods or services separately when control over such goods/services are transferred. Recognise sale of car at the time of delivery of car. Recognise Sale of Car Services only when such services becomes Due. |
| "Series of Goods & Services" that are substantially the same and have the same pattern of transfer (i.e. delivered over the time in a repetitive or consistent pattern) | Examples: 1. 3 Years Maintenance Services, each year is considered distinct 2. Subscription Services of Monthly magazine. 3. Security Services provided to a Building; each day service is distinct because customer benefits from each day's security. But service is delivered consistently. 4. Auditing Services | It is treated as Single Performance Obligation provided over the contract period. Revenue is recognised generally on SLM basis or based on any reasonable proportion. |

MEANING OF DISTINCT GOODS & SERVICES

Product or Service is considered distinct if:

- a) The customer can benefit from it either on its own or with other resources that are readily available.

Example: A company sells a smartphone that works with any standard charger. The phone is distinct because the customer can use it immediately with any charger.

- b) All products or services are separately identified in the context of the contract

Example: If a company sells a computer and also provides training, both the computer and training are distinct because they don't depend on each other and separately identified in the invoice.

Example of distinct goods and services:

A software company sells a license for its software and offers installation services. The installation doesn't modify the software and can be done by others. The customer can use the software without the installation, so the software license and installation service are distinct. They are treated as two performance obligations.

Important Cases:

| | |
|---|---|
| <p>Significant Modification and customization services</p> | <ol style="list-style-type: none"> 1. Goods and services are bundled in such a way that they create one combined product, which is highly customized or modified. 2. This combined product is so dependent on the customization that it cannot function without it. 3. Because of this high level of customization, the individual goods and services cannot be separated; they work together as a single integrated solution. <p>Conclusion: In cases of customization services, the customer cannot benefit from each individual product in the bundle of goods and services on its own. The bundle works as a single customized product, and the individual components are inseparable.</p> <p>Example: The company promises to deliver customized software that needs to be heavily modified to work with the customer's existing systems. Since the software is significantly customized, it can't be used separately from the customization service. Here, the software and customization service are treated as one combined item because they are inseparable</p> |
| <p>Significant Integration Services</p> | <p>When a company provides significant integration services, it means that they combine different goods or services together into one single output.</p> <p>These goods or services cannot be treated as separate items because they are integrated to create the final product or service that the customer wants.</p> <p>If the company is responsible for integrating all the goods or services, they are not treated separately. Instead, they form a bundle that works together to provide the final product.</p> <p>Example: In a construction contract, a contractor is responsible for managing different tasks, like engineering, site preparation, and building. These tasks are integrated to complete the project, like constructing a building.</p> <p>Conclusion: When the company provides an integration service, it makes sure that all the goods or services are combined into one final product, and individual parts can't be separated for revenue purposes.</p> |
| <p>Highly interrelated or interdependent</p> | <p>If the multiple goods of a contract are so connected or linked with each other, they may not be separated for revenue recognition purpose.</p> |

| | |
|--|--|
| goods and services | <p>Example: A smartphone company selling a phone along with a specific case and screen protector as a package. If the case is designed to fit that phone perfectly and the screen protector is made for that specific model, you can't just think of the phone as one thing and the accessories as separate. They are interrelated because the accessories enhance the phone's usability and protection. If a customer buys the phone, they likely need the case and protector to get the full benefit of the device, making these items highly interdependent. Hence all these items are not distinct.</p> |
| Customer has option to purchase additional goods or services in future at discounted price | <p>If such option provides a material right to the customer that it would not receive without entering the contract, then such option is a separate performance obligation, since customer has paid the entity an additional consideration for option of future goods and services to be delivered if customer opted.</p> <p>Example: Take Gym membership at 12,000 for a year and get 50% discount for next year membership. Here revenue can be recognised as under: Total expected consideration is 18,000 for two years. Hence revenue to be recognised as 9,000 for each year. Out of 12,000 collection, treat 3,000 as liability.</p> |
| Long Term Contracts | <p>It may be appropriate to treat a three-year services contract as three separate one-year performance obligations, if the contract can be renewed or cancelled by either party at each year end.</p> <p>Examples: Cable Services Annual Maintenance Contracts</p> |

7. STEP - 3

DETERMINE THE TRANSACTION PRICE

Objective: To Predict the Total amount of Consideration to which the entity will be entitled from the Contract.

Meaning: The transaction price is the amount of consideration that an entity expects to be entitled to in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties such as GST.

(Transaction Price is not always the Agreed Contract Price)

How to estimate the transaction price?

| | |
|---|-----|
| Agreed Contract Price as base | XXX |
| (+/-) Variable Consideration such as Incentives, discounts, rebates, Bonus, penalties | XXX |

| | |
|---|------------|
| (-) Refund Liability for goods expected to be returned | XX |
| (+) Restocking Fees to be charged in case of goods expected to be returned | XX |
| (+/-) Significant Finance Component (Interest) | XX |
| (+) Fair Value of Non-Consideration | XX |
| (-) Consideration payable to Customer (Vouchers/Cash Backs/Slotting Fees/Price Protection) | XX |
| Transactions Price | XXX |

Special Cases of Transaction Price

| CASES | ACCOUNTING TREATMENT | REMARKS |
|---|--|--|
| Discount Vouchers for Next Purchase by customer (Also known as Loyalty points) | <p>Total amount of consideration at the time of First Purchase by customer is divided into two parts:</p> <ul style="list-style-type: none"> • Transaction price for current purchase • Advance Received for next purchase by customer • Advance received is treated as liability first and treated as Revenue at the time of either second purchase by customer or on expiry of discount voucher period. <p>How to calculate the Advance Amount? Expt. Next Purchase Amt. X Discount % X Probability %</p> | <p>Customer has option to purchase additional goods or services in future at discounted price (Already discussed in Step 2)</p> |
| Penalties | <p>Where the penalty is inherent in determination of transaction price, it shall form part of variable consideration.</p> | <p>Where an entity agrees to transfer control of a good or service in a contract with customer at the end of 30 days for Rs. 100,000 and if it exceeds 30 days, the entity is entitled to receive only Rs. 95,000, the reduction of Rs. 5,000 shall be regarded as variable consideration.</p> |
| Refund Liabilities | <p>An entity shall recognise a refund liability if the entity receives</p> | <p>Bank A/c Dr. To Refund Liability A/c</p> |

| | | |
|--|--|--|
| | consideration from a customer and expects to refund some or all of that consideration to the customer. | (Refund liability will be either reversed in case of actual refund or it will be transferred to revenue in case of no refund) |
| Sale with Right of Return (other than consignment sale) | Recognise the following: (a) Revenue , for which the amount is not to be refunded (b) A refund liability for portion to be refunded (c) Show Inventory with customer in respect of Portion of transaction price to be refunded. | Bank A/c Dr. To Revenue A/c To Refund Liability A/c (That portion which is not expected to Refund liability will be either reversed in case of actual refund or it will be transferred to revenue in case of no refund) |
| Accounting for restocking fees for goods that are expected to be returned | Restocking fees for goods that are expected to be returned would be included in the estimate of the transaction price at contract inception and recorded as revenue when (or as) control of the good transfers. | Entities sometimes charge customers a restocking fee when a product is returned. This fee may be levied by entities to compensate them for the costs of repackaging, shipping and/or reselling the item at a lower price to another customer. |
| Service Type Warranties | Account this warranty as a separately performance obligation under Ind AS 115 and allocate the transaction price to this PD also. | Service Type warranty provides additional services by Seller entity in case of product default. |
| Assurance type warranties (No additional services are provided) | It is not a separate performance obligation. A Provision must be made as per Ind AS 37 for Warranty Expense through Profit and Loss. | It is a minimum warranty required by law. Hence no separate performance obligation. |
| Non-Cash Consideration (In Kind) | Measure the consideration at Fair Value of assets or goods or services received if possible. If Fair Value of consideration received cannot be estimated reliably, then consideration is equal to the Stand-alone selling price of goods & Services promised. | Example - Issuing shares or other equity instruments, or advertising or providing equipment. Once revenue is recognised as Fair Value, if the fair value of non- cash consideration varies because of its form, then do not adjust the transaction price for any change in the fair value. |

| | | |
|---|--|--|
| <p>Customer provided goods or services to entity</p> | <p>If entity obtains control over such goods or services, then it is treated as Consideration received in Kind and Measured at Fair Value.</p> | |
| <p>Consideration payable to customer against which entity receives distinct goods/services</p> | <p>Recognise purchase of goods/services separately, do not adjust revenue.</p> <p>If the consideration payable exceeds the fair value of goods/services received, the excess shall be reduced from transaction price of Goods and Services sold.</p> | <p>The consideration payable to a customer is 15,000 for distinct goods. The standalone price of distinct goods purchased is 13,000. Rs. 2,000 shall be deducted from the Transaction price of Goods and Services sold.</p> |
| <p>Consideration payable to customer other than above (not in exchange of goods/services)</p> | <p>Reduce it from Transaction Price.</p> | <p>For Example - Cash Vouchers or Coupons, slotting fees, price protection.</p> |
| <p>Non-refundable Upfront Fees</p> | <p>If it is not related to separate Goods & Services, then fees to be accounted for as an Advance payment for future Goods and Services transferred to Customers.</p> | <p>Jio Provides a New Data Connection to customer for High-Speed Internet services. It Charge a onetime registration and activation fees Rs. 1000/-</p> <p>For Data Services, customer need to select any monthly plan based on its requirement.</p> <p>Activity of Registration and Activation is not a separate service hence one-time Fees charged is treated as advance collected for future data services to be provided.</p> |
| <p>Significant Finance Component in case PO is satisfied but amount will be received in future</p> | <p>If performance obligation is satisfied but customer will pay in future. Revenue shall be recognised at Cash Price Equivalent.</p> <p>Cash Price Equivalent means PV of Future Cash Flow or Current</p> | <p>Goods sold to customers, but customer will pay after 1-year Rs. 1,10,000.</p> <p>Discounting rate is 10%</p> <p>Cash Price equivalent is PV of Future Cash Flow i.e. 1,00,000 to</p> |

| | | |
|---|---|---|
| | <p>Standalone price of goods and services.</p> <p>Any amount received over, and above Cash Price Equivalent will be treated as Finance Income (P&L).</p> | <p>be recognised immediately.</p> <p>10,000 is interest which is transferred to P&L (other income) after 1 year.</p> |
| <p>Significant Finance Component in case Advance Received from Customer, but PO will be satisfied in future</p> | <p>Consideration received is treated as Liability.</p> <p>Calculate Interest expense on above liability and charge it to P&L.</p> <p>Recognise the revenue on the date when PO is satisfied by reserving the liability.</p> | <p><u>Date of Receipt:</u></p> <p>Bank A/c Dr. To Advance Collected A/c</p> <p><u>Year End:</u></p> <p>Interest Exp. A/c Dr. To Advance Collected A/c</p> <p><u>When PO is satisfied:</u></p> <p>Advance Collected A/c Dr. To Revenue A/c</p> |

Note: Ignore Finance Cost (Interest Element) in following cases

- 1) Customer paid in advance; Performance obligation is satisfied at the request of customer.
- 2) If customer withholds the payment of entity for other reasons such Quality checks and not due to financial crunch.
- 3) If advance collected from customer is just for protection against bad-debts.

Example on Restocking Fees:

An entity enters into a contract with a customer to sell 10 units of a product for Rs. 100 per unit. The customer has the right to return the product, but if it does so, it will be charged a 3% restocking fee (or Rs. 3 per returned unit). The entity estimates that 10% of the sold units will be returned. Upon transfer of control of the 10 units, the entity will recognise revenue of Rs. 903 [(9 units not expected to be returned x Rs. 100 selling price) + (1 unit expected to be returned x Rs. 3 restocking fee per unit)]. A refund liability of Rs. 97 will also be recorded [1 unit expected to be returned x (Rs. 100 selling price - Rs. 3 restocking fee)]

How to Estimate the Variable Consideration

(a) Expected Value Method:

It is used when there are more than 2 possible outcomes. Under this method, consideration is measured at sum of probability weighted amounts from a range of possible outcomes.

Example 4:

Entity will get incentive from customer if completed before time as under:

| | |
|---|--------------|
| Completion by 12 months - 10% Incentive x 40% Probability = | 4 |
| Completion by 12-15 months - 7.5% Incentive x 50% Probability = | 3.75 |
| Completion by 15 -18 months - 5% Incentive x 10% Probability = | 0.5% |
| Incentive to be Considered = | 8.25% |

(b) Most Likely Amount Method:

It is used when there are only 2 possible outcomes. In this method, single most likely outcome is taken which has highest probability.

Example 5:

If Completion within 12 Months, then 10% Incentive - Probability is 60%

If Completion beyond 12 Months then No Incentive - Probability is 40%

Since probability is more for within 12 months hence Variable consideration is 10%

8. STEP - 4

ALLOCATE THE TRANSACTION PRICE TO THE PERFORMANCE OBLIGATIONS

- ✓ Contract Identification is done
- ✓ Performance Obligations (P.O.) are also identified (may be Multiple Goods & Services)
- ✓ Transaction Price is also finalized.

Now, the time is to **allocate the transaction price** into various distinct performance obligations in the ratio of "**Stand-alone Selling Price (SSP)**" of each PO

HOW TO IDENTIFY STAND-ALONE SELLING PRICE?

- 1) **General Rule:** Take Observable SSPs i.e. prices at which each PO is sold separately.
- 2) **Exception:** If observable SSP of one or more PO is not identified, then use the following methods to determine SSP:
 - a) **Adjusted Market Assessment Approach:**
Take Competitor's Price of similar goods/services
(+/-) Adjust with Own Costs & Margins
 - b) **Estimated Cost Plus Margin Approach:**
Estimate the Cost of Providing goods/services
(+) Estimated Margin %
 - c) **Residual Approach:**
If SSP of any one or more Goods & Services are not identifiable from above methods, then this approach is used as under:
 - Total Transaction Price of the Contract (All PO)
 - (-) SSP of other Goods/Services identified

Example 6:

There are 3 performance obligations (3 different products) in a contract with transaction price is Rs. 50,000.

Standalone SP of all 3 products are:

A- Rs. 25,000

B- Rs. 20,000

C- Rs. 15,000

Allocation of Transaction price in the ratio of SSPs are:

A - $50,000/60,000 \times 25,000 = 20,833/-$

B - $50,000/60,000 \times 20,000 = 16,667/-$

C - $50,000/60,000 \times 15,000 = 12,500/-$

TREATMENT OF DISCOUNTS AND VARIABLE CONSIDERATIONS WHILE ALLOCATING THE TRANSACTION PRICE:

1) Allocating the Discount to one or more PO but not all PO

Case 1: Discount is available on Combo Product and Combo product is delivered at same time. Allocate the Combo Price to Combo products and remaining amount of TP to the other individual products.

Example 7:

There are 3 Products X, Y & Z. Individual SSPs are 2,50,000 for X, 2,00,000 for Y and 1,50,000 for Z. However, the entity regularly sells X & Y (combo) together also at a price of 3,50,000.

There is a contract to supply all 3 products at 5,00,000.

Control over X & Y will be transferred at same time.

Solution:

Treat X & Y as single performance obligation and allocate 3,50,000 to them and recognise the Revenue only when both are transferred together at same time.

The transaction price of product Z is Rs. 1,50,000 and revenue will be recognised only when Z will be transferred.

Case 2: Discount is available on Combo Product and, but Combo products are delivered at different points in time individually.

Allocate the Combo price to each of combo products in their standalone selling prices, Remaining TP is allocated to other non-combo products

Example 8:

There are 3 Products X, Y & Z. Individual SSPs are 2,50,000 for X, 2,00,000 for Y and 1,50,000 for Z. However, the entity regularly sells X & Y (combo) together also at a price of 350,000.

There is a contract to supply all 3 products at 5,00,000.

Control over X & Y will be transferred at different points in time.

Solution:

Step 1:

Allocate 3,50,000 combo price to X & Y first in their SSP ratio:

X - 1,94,445

Y - 1,55,555

Step 2:

Allocation of TP to all products are:

X - 1,94,445

Y - 1,55,555

Z - 1,50,000

Recognise Revenue individually when control over each such product is passed to customer.

2) Variable Consideration is related to one PO only and not all

There is a contract to supply Software along with Customized Installation to the system. Total Transaction price of Contract is Rs. 1,00,000.

Allocated TP are:

- Software - Rs. 70,000
- Installation - Rs. 30,000

However, if customized installation is done within 1 month, then customer will pay incentive of Rs. 10,000. It is expected that installation will be completed within 1 month.

Here Allocated Prices will be:

- Software - 70,000
- Installation - 40,000 (with variable consideration)

3) Variable Consideration relates to One Specific PO only, but allocation of Variable Consideration doesn't reflect reasonable allocation:

- If there is a Variable Consideration which is related to one PO and not related to others.
- But Allocating such Variable consideration to such related PO doesn't reflect the reasonable allocation of Transaction price. Then variable consideration shall be allocated to all other PO also on general allocation principal basis.

Example 9:

Entity enters into contract to supply two different distinct licenses X & Y. Total SSP are:

- X - 5,00,000
- Y - 7,00,000

X will be transferred immediately, but Y will be transferred after one Month.

As per the Contract the price for X is fixed Rs. 2,00,000 and price for Y is based on % of Revenue generated from use of Y. Estimated amount is Rs. 9,00,000

Solution:

Allocating fixed consideration to X and Variable Consideration to Y only is not a reasonable allocation as it will not reflect their standalone selling price.

Instead, both fixed and variable consideration should be allocated to X and Y in their stand-alone selling prices as under:

License X:

- Fixed Portion Rs. 83,333 and Variable Portion Rs. 3,75,000

License Y:

- Fixed portion Rs. 1,16,667 and Variable Portion Rs. 5,25,000

Revenue for X will be recognised immediately as under:

| | | |
|--------------------|------------------------|----------|
| Bank A/c Dr. | 2,00,000 | |
| Receivable A/c Dr. | 2,58,333 | |
| | To Revenue (License X) | 4,58,333 |

Revenue for Y will be recognised after one month as under:

| | | |
|--------------|------------------------|----------|
| Bank A/c Dr. | 9,00,000 | |
| | To Receivable A/c Dr. | 2,58,333 |
| | To Revenue (License X) | 6,41,667 |

9. STEP 5

RECOGNIZE REVENUE WHEN (OR AS) THE ENTITY SATISFIES A PERFORMANCE OBLIGATION

When the Revenue should be recognised?

Revenue shall be recognised when the entity **satisfies Performance Obligation** in a contract.

When the Performance Obligation will be treated as Satisfied?

Performance obligation will be treated as Satisfied when **Control over Goods & Services is transferred** to the customer.

How is the Control over Goods and Services transferred?

Control over Goods and Services is transferred to the customer in two ways (based on nature of Performance obligations):

- a) **Control is transferred over the Period of Time:** Recognise the revenue over the period.
- b) **Control is transferred at a Point in Time:** Recognise the revenue at a point in time.

(**Note:** Control means decision making rights on Goods & Services)

Control is transferred over the period if any of the following criteria is met:

- a) The **customer simultaneously receives and consumes the benefits** as the entity performs such as cleaning services, consultancy services, maintenance services, cable services etc; (or)
- b) **Customer controls the Asset as it is created** or enhanced by Entity's performance such as Building construction (WIP); (or)
- c) **Asset created doesn't have any alternative use** (no asset for customer till it is completed) to the entity and **entity has enforceable right to receive the payment** for the work done till date.
E.g. Such as building customized software for customer, but it will give benefit only when the development is complete meanwhile entity has the right to receive progress payments.

Note: in all other cases when the above 3 conditions are not satisfied, **control will be treated as satisfied at a point in time.**

More Examples of Control Transferred over the Period of Contract:

- 1) Construction of space satellite with different specifications.
- 2) Entity is providing Payroll processing services on monthly basis.
- 3) Transportation of Goods services through sea when it takes a longer time to reach the goods.
- 4) Auditing Services performed over the contract period, customer will get the audit opinion only on the completion of audit but entity has right to get progress payments as the service performed.
- 5) Health Clubs (Gyms) services where customer simultaneously receives and consumes the benefits from entity's performance.

How to Recognise Revenue over Time?

To recognise the revenue over the period of contract, we need to measure the **"% of Progress of Work completed till date"**. Following are the methods to measure % of Progress of Work:

| Output Methods | Input Methods |
|---|--|
| <p>% of Progress is based actual output provided to customer till date.</p> <p>Actual output can be in the form of:</p> <ul style="list-style-type: none"> • Value of Goods/services • No. of Goods/services • Surveys of Performance completed till date | <p>% of Progress is based entity's efforts till date.</p> <p>Entity's Efforts can be in the form of:</p> <ul style="list-style-type: none"> • Cost incurred till date • Machine or Labor Hours consumed till date |
| <p>Formulae:</p> $\frac{\text{Value Provided till date} \times 100}{\text{Total Value to be Provided}}$ | <p>Formulae:</p> $\frac{\text{Cost Incurred till date} \times 100}{\text{Total Estimated Cost of Contract}}$ <p>Note:</p> <ul style="list-style-type: none"> • Abnormal Cost should be ignored • Cost of Major Component not yet installed, or which don't actually reflect how much work the company has done. Such as AC or elevators purchased not yet installed. |
| <p>Important Note for Input method:</p> <p>When a company is using the input method to measure its progress in delivering goods or services, it should not include any inputs that don't actually reflect how much work the company has really done in transferring control of the product or service to the customer. The idea is to only count the efforts that truly show the company is delivering what it promised, not just any activity or expense.</p> <p>Example:</p> <p>Company A is building a customized software solution for a client. The contract states that the project will take 12 months and cost ₹1 crore</p> <p>During the first month, Company A purchases an expensive software license costing ₹20 lakh, which is necessary to complete the project. However, buying the software license doesn't mean the project is 20% complete. Company A should exclude the cost of the software license (₹20 lakh) from its revenue recognition calculation, because it doesn't directly reflect progress in delivering the customized software to the client.</p> | |

What are the cases when Revenue is recognised at a point in Time?

- Entity has right to collect the consideration only when goods/services **are delivered** to the customer.
- Wholesaler entity has given an option to Retailer Entity **to pay only when goods are ultimately sold to customer.**
- Constructing a Machine for customer, machine takes a long time to complete the construction, entity will get the consideration in installments. If contracts terminate entity has right to retain the payment already received and retain the asset also **but cannot demand another payment from customers.**

- A customer gets significant risks and rewards of ownership of goods and customer has started directing the asset based on his own requirements.

10. SOME SPECIAL AREAS

PRINCIPAL VS AGENT CONSIDERATION

Entity is acting as a principal if any of the following conditions are satisfied:

- Entity has overall responsibility of fulfilling the contract.
- Entity has inventory risk (Goods if not sold can-not be returned back).
- Entity has discretion in setting the price of goods and services

| | |
|---|--|
| If Entity is Acting as a Principal | Recognise Gross amount of Consideration as Revenue |
| If Entity is Acting as an Agent | Recognise Net Amount as Revenue i.e. commission amount charged from principal |

REPURCHASE AGREEMENTS

A repurchase agreement is a contract in which an entity sells an asset (goods) and also promises or has the option to repurchase the same asset (goods).

Case 1: Entity has the right to repurchase the goods (Call Option or Forward Option)

| Call Option may not be exercised by Entity | Call Option may be exercised by Entity | |
|--|---|--|
| Recognise the Revenue as per Ind AS 115 (Five Steps Model) | Repurchase price is lower than original selling price: <ul style="list-style-type: none"> Treat the contract as a Lease. Consideration Received is treated as Deposit liability to the extent of repurchase price. Balance is treated as Income which is to be recognised over the period of the contract. Subsequently, if there is change in decision, deposit liability is treated as Revenue. | Repurchase price is equal to or higher than original selling price: <ul style="list-style-type: none"> Treat it as Finance Arrangement Entire Consideration is treated as Loan Liability Consideration Received in the Beginning and Amount payable at the time of repurchase is treated as Finance Cost over the contract period. If there is change in decision subsequently, then loan is reversed and treated as Revenue. |

Case 2: Customer has right to sell the Asset (Put Option) to entity and entity has obligation to purchase

| | |
|---|--|
| Repurchase price is lower than original selling price | Repurchase price is equal to or higher than original selling price or Market Price |
| <u>Situation 1</u> | <ul style="list-style-type: none"> Create Refund liability for goods to be returned by customer. |

Customer will not get any economic incentive in exercising the put option i.e. customer may not exercise the option:

- Seller entity shall recognise the revenue as per Ind AS 115

Situation 2

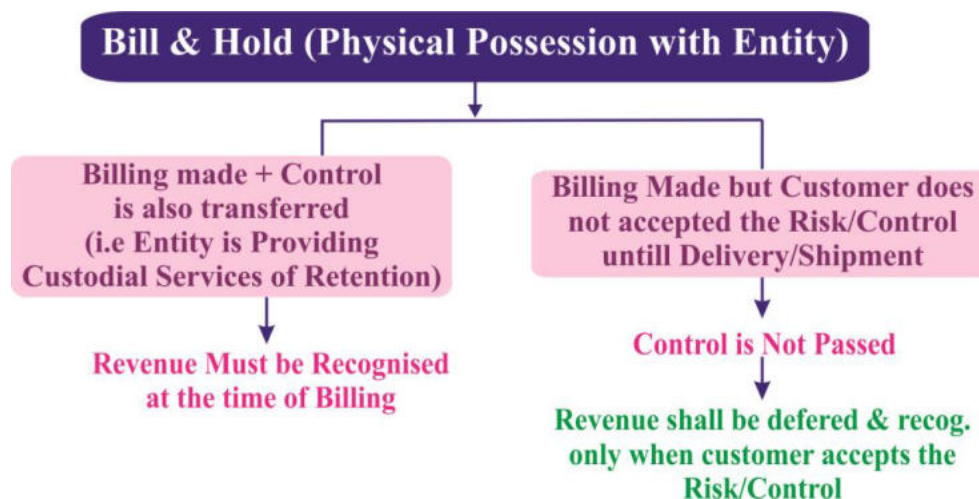
Customer will get significant economic incentive to exercise the put option, i.e. it is likely that customer will exercise the option:

- Treat the contract as a Lease.
- Consideration Received is treated as Deposit liability to the extent of repurchase price
- Balance is treated as Income which is to be recognised over the period of the contract.
- Subsequently, if there is change in decision, deposit liability is treated as Revenue.

- Recognise revenue for goods not expected to be returned by customer
- Goods expected to be returned are treated as Inventory of Entity.

BILL AND HOLD

If the billing is done but delivery is on hold at the request of the customer, Revenue shall be recognised if entity has separately kept such goods, and it does not have any managerial authority or involvement over such goods (i.e. entity will not or is unable to sell such goods to another customer).



LICENSES OF INTELLECTUAL PROPERTY

Ind AS 115 provides guidelines on how to recognize revenue from licenses of intellectual property (IP). The way revenue is recognized for IP licenses is different from how it's recognized for other goods or services.

What is an Intellectual Property License?

A license allows someone to use or access the intellectual property of a company. Intellectual property could be things like software, movies, music, franchises, patents, or trademarks.

How to recognise the revenue from providing license of Intellectual Property?

Revenue recognition depends on Nature of License as under:

- Right to access:** Revenue is recognized over time because the customer is continuously benefiting (like software updates).
- Right to use:** Revenue is recognized at a point in time because the customer gets the license to use something as it is (like a finished movie).

Examples

| Right to Access | Right to Use |
|---|--|
| Infosys created Customized Software for a Bank. Banks will use and access the software throughout the year along with updates. | A Production Company sells its movie rights to Jio Cinemas to run such movies. |
| BCCI provides exclusive license to Dream 11 as sponsorship rights. License permits Dream 11 to use the team name and logo on its products, including display products, and in its advertising or marketing materials. | T-series sells its music rights to a film maker. |
| Franchise Agreements | |

Example

Pogo has created a popular television show called "Chhota Bheem". Pogo grants a three-year license to Toy Manufacturer for use of the character "Chhota Bheem" on its toys. As per the contract, pogo will continue to produce the show, popularize the character, carry out marketing activities. Toy Manufacturer produces and sells —Chhota Bheem toys. In this case, the license provides access to Pogo's Intellectual Property (IP). Pogo will undertake activities that significantly affect the IP by production and marketing of the show, development of the characters. Toy manufacturer is directly exposed to any positive or negative effects by Pogo's activities ie. how the show is received by kids and their parents. These activities are not separate performance obligations as they do not transfer a good or service to Toy Manufacturer separate from the license. Hence, Pogo will recognize revenue over time.

SERVICE CONCESSION ARRANGEMENTS

Meaning of SCA:

- Service Concession Arrangement involves a **private sector entity (an operator)** constructing the **infrastructure used to provide the public service** and operating and maintaining that infrastructure for a specified period of time.
- The **operator is paid for its services** over the period of the arrangement.
- Such an arrangement is often described as a **'build-operate-transfer' (BOT contracts)**
- Asset created under this contract is **not a PPE for Operator entity** it is a public property.

Accounting of SCA in the books of Operator Entity:

Accounting depends on how the consideration is received by Operator Entity:

| Entity has right to receive Fixed Amount of Cash from Government | Entity has right to collect Toll Charges from public for use of Asset |
|--|--|
| <p>Expenditure incurred by the entity to build the Asset is amortised over the period of contract: Construction Exp. (Deferred) A/c Dr. To Bank A/c</p> | <p>Expenditure incurred by the entity to build the Asset is amortised over the period of contract: Construction Exp. (Deferred) A/c Dr. To Bank A/c</p> |
| <p>Profit and Loss A/c Dr. To Construction Exp. (Amortised)</p> | <p>Profit and Loss A/c Dr. To Construction Exp. (Amortised)</p> |
| <p>Recognise "Financial Asset" at Present Value of Fixed Cash Inflows as per Ind AS 109: Financial Asset A/c Dr. (Debtor) To Revenue A/c</p> | <p>Recognise "Intangible Asset" at fair value of construction service as per Ind AS 38: Intangible Asset A/c Dr. To Revenue A/c</p> |
| <p>Financial Asset A/c Dr. (Unwinding of Discount) To Finance Income A/c</p> | <p>Amortisation Exp. A/c Dr. To Intangible Asset A/c</p> |
| <p>Bank A/c Dr. To Financial Asset (Debtor) A/c</p> | <p>Bank A/c Dr. To Revenue A/c (Toll Collection)</p> |

11. CONTRACT COSTS

Contract costs are of two types:

- 1) Contract Acquisition Costs
- 2) Contract Fulfillment Costs

| Contract Acquisition Cost | Contract Fulfillment Costs |
|--|---|
| <p>Contract acquisition cost is also of two types:</p> <ol style="list-style-type: none"> a) Sunk Cost - Cost incurred to acquire the contract, but it is not recoverable. Hence it is charged to P&L a/c immediately b) Incremental Cost to obtain the contract - Such cost are recoverable from customer hence it is treated as WIP and amortise over the contract period. | <p>Examples are Material, Labor etc.</p> <ol style="list-style-type: none"> a) If costs incurred in fulfilling a contract with a customer are covered under another Standard (such as Ind AS 2 'Inventory', Ind AS 16 'Property, Plant, and Equipment' and Ind AS 38 'Intangible Assets'), an entity accounts for those costs in accordance with those Standards. b) If these costs are not covered under other Ind AS then they are also treated as WIP and amortisation is required over the contract period. |

IMPAIRMENT OF CONTRACT COST CAPITALISED:

An entity recognises an impairment loss if:

- The carrying amount of an WIP Asset exceeds
- The remaining amount of consideration that the entity expects to receive in connection with the related goods or services **less** any directly related contract costs yet to be recognised.

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FINANCIAL INSTRUMENTS

INDAS – 109, 32 & 107

(Note: Refer Practical Concept Builder Example Book also along with these notes)

UNIT - 1

BASIC KNOWLEDGE ABOUT FINANCIAL INSTRUMENTS

1. WHAT IS FINANCIAL INSTRUMENT?

Any contract creates Financial Assets for One Entity and Financial Liability or Equity for Another Entity.

2. WHAT IS A FINANCIAL ASSET?

A Financial Asset is any asset i.e.

- (a) cash, includes cash deposits with banks
- (b) any equity instrument of another entity (Investment in Equity Shares such RIL)
- (c) a contractual right to receive cash or another financial asset from another entity (such as trade receivables, loan receivables, bonds receivables)
- (d) a contractual right to exchange the financial assets or financial liability with another entity under the conditions that are favorable to the entity.
- (e) Derivative Contracts eg. Futures/Options etc. (Favorable Terms)

| ITEMS of ASSETS | FA - Yes/No |
|---|-------------|
| Building | No |
| Receivables | Yes |
| Inventory | No |
| Advance Tax | No |
| Loan Given | Yes |
| Rent Advance | No |
| 3 month rent deposit with land lord as security | Yes |
| Advance to Supplier | No |
| Intangible Assets | No |
| Investment Property | No |
| Capital WIP | No |
| Investment in Debentures/Bonds | Yes |
| Investment in Gold | No |
| Investment in Gold Bonds | Yes |
| Equity Shares held in other company | Yes |

| | |
|---|-----|
| Right of Use Asset | No |
| Cash & Cash Equivalents | Yes |
| Perpetual Debt Instruments eg. Perpetual Bonds or debentures | Yes |
| Lease Receivable for Lessor | Yes |

3. WHAT IS FINANCIAL LIABILITY?

Financial liability is any liability i.e.

- (a) A contractual obligation *to deliver cash* (such as trade payables, loan liabilities) *or to deliver another financial asset* to another entity.
- (b) A contractual obligation *to exchange* the financial asset or financial liability with another entity under the conditions which are *potentially unfavorable to the entity*.
- (c) A contract that will or may be settled in entity's *own equity instruments* and is:
A *non-derivative* for which the entity is or may be obliged to *deliver a variable* number of entity's own equity instruments; *(a liability which is to be settled in variable no. of own equity shares, which are used as currency)*
- (d) *Derivative Instruments (Unfavorable Terms)*

| ITEMS of LIABILITIES | FL - Yes/No |
|--|-------------|
| Loan Taken | Yes |
| Creditors/Payables | Yes |
| Salary Payable | Yes |
| Credit balance of debtors | No |
| Debentures Issued | Yes |
| Provision for Income Tax | No |
| Security deposit accepted (refundable) | Yes |
| Preference Share capital redeemable Mandatory | Yes |
| Dividend declared | Yes |
| Financial Guarantee Given | Yes |

4. WHAT IS EQUITY?

(NO FIX OBLIGATION TO MAKE PAYMENT)

An equity instrument is any contract which creates *a residual interest in the net assets of an entity* after deducting all of its liabilities.

Equity Holder can-not claim on the company, if he/she can claim he is not equity he is someone else.

The most important characteristic of equity instrument is *it does not have contractual obligation*.

| ITEMS | Equity - Yes/No |
|-------------------------------|-----------------|
| Equity Share Capital | Yes |
| Reserves and Surplus | Yes |
| Redeemable Pref Share Capital | No |
| Irredeemable Pref. Shares | Yes |

| | |
|---|--|
| Perpetual Debt Instruments (Irredeemable) | Yes |
| 100% Compulsorily Convertible Debentures | Yes |
| Convertible Debentures at the option of Holder | Compound One Part is FL another Part is Equity |
| Share Warrants | Yes |
| Convertible Debentures at the option of Issuer | Compound One Part is FL another Part is Equity |
| Irredeemable Preference shares with non-cumulative dividend | Yes |

Special Financial Instruments

| | | |
|--|---|-----------------------------|
| Borrowed funds (Debentures or Pref. Shares Issued) | Interest or Dividend payable is mandatory | It is a financial liability |
| Borrowed funds (Debentures or Pref. Shares Issued) | Interest or Dividend payable is discretionary | It is a financial liability |
| Convertible Debentures or Preference Shares Issued | Convertible into Variable No. of Equity Shares in Future | It is a financial liability |
| Convertible Debentures or Preference Shares Issued | If Compulsory Convertible into Fixed No. of Equity Shares in Future | It is Equity |
| Convertible Debentures or Preference Shares Issued | Optionally Convertible into Fixed No. of Equity Shares in Future | It is a financial Liability |

Recognition of Incomes and Expenses

| | |
|--|--|
| Interest/Dividend Income on Financial Assets | Should be recognised in Profit and Loss |
| Interest Expense on Financial Liability | Should be recognised in Profit and Loss |
| Any Expense on Equity Instrument | Should be recognised in Retained Earnings directly |

UNIT - 2**RECOGNITION & MEASUREMENT OF FINANCIAL INSTRUMENTS**

Financial Instruments are:

- 1) Financial Assets
- 2) Financial Liabilities
- 3) Equity

We will discuss each of the above separately.

1. FINANCIAL ASSETS**CLASSIFICATION OF FINANCIAL ASSETS:**

| | |
|---|--|
| <p>Categories of Financial Assets</p> | <ol style="list-style-type: none"> 1. Financial Assets measured as Amortised Cost (AMC) 2. Financial Assets measured as Fair Value through OCI (FVTOCI) 3. Financial Assets measured as Fair Value through P&L (FVTPL) |
| <p>Amortised Cost (AMC)</p> | <p>If the intension of investor is to hold the Assets till maturity and collect contractual cash flows only (i.e. Principal and Interest) then such Financial Asset shall be measured at Amortised Cost.</p> <p>Examples:</p> <ul style="list-style-type: none"> • Fixed Deposits • Investment in Unlisted Debentures/Bonds • Trade Receivables • Loan Receivables • Staff Advances <p>Any Financial Asset which doesn't have fixed maturity date will not cover under this category.</p> <p>Key Words: Hold to Collect & SPPI</p> |
| <p>Fair Value through OCI (FVTOCI)</p> | <p>If the intension of investor is Not to hold the Assets till maturity and sell it before maturity date, then such Financial Asset shall be measured at Fair Value and difference is transferred to OCI.</p> <p>If the Intension is not clear i.e. an Investor may sale or hold then also such Financial Asset will be categorized under FVTOCI.</p> <p>Here, investor wants to collect some of the contractual cash flows (Principal and Interest) and Other Cash Flows (Profit on sale of Investment)</p> <p>Examples:</p> <ul style="list-style-type: none"> • Investments in Government bonds where investment period is likely to be shorter than its maturity period. <p>Key Words:</p> |

| | |
|--|--|
| | Hold to Collect and Sale and SPPI |
| <p>Fair Value through P&L (FVTPL)</p> <ul style="list-style-type: none"> • No Fixed maturity • No SPPI • No Contractual Cash Flows | <p>If the intension of investor is to hold the asset for Trading Purpose only, then such Financial Asset shall be measured at Fair Value and difference is transferred to profit and loss.</p> <p>Those financial assets which doesn't provide guaranteed contractual cash flows comes under this category</p> <p>Examples:</p> <ol style="list-style-type: none"> 1. Investment in Equity Shares of Other Company 2. Derivative Instruments |
| <p>Exception for Investment in Equity Shares:</p> | <ol style="list-style-type: none"> 1. Investment in Equity Shares of other companies is categorized under FVTPL. 2. However, if Investments in Equity Shares are not held for Trading Purpose, then Investor has the choice to designate such investment under FVTOCI category instead of FVTPL. 3. This option is irrevocable i.e. entity must follow always if applied once and cannot be reclassified to FVTPL. 4. Conclusion: <ul style="list-style-type: none"> (a) Investment in Equity Shares (HFT) - FVTPL Always (b) Investment in Equity Shares (Not HFT) - Choice of FVTOCI and FVTPL |

ACCOUNTING TREATMENT OF FINANCIAL ASSETS:

| | |
|---|--|
| <p>Financial Assets Under Amortised Cost (AMC)</p> <p>(Refer Practical Examples 6 to 8)</p> | <p>Initial Recognition</p> <ol style="list-style-type: none"> 1) Recognise at Fair Value 2) Fair Value here means Present Value of future Cash Inflows 3) Present Value shall be calculated using Market Interest Rates (also called Effective Interest Rate i.e. ERI) 4) Transaction Cost: it is treated as current outflow and added to the Initial outflow of Asset. or if is inflow then deducted from Initial Outflow. 5) Any Difference between total outflow and present value is recognised as under: <ul style="list-style-type: none"> (a) In case of Staff Loan - Employee Benefit Expenses over the life of Loan (Prepaid Employee Benefit Exp.) (b) In case of Lease Transaction - Prepaid Lease Rent to be amortised over the lease term (c) In case of Loan by Parent to subsidiary - Treated as Investment Cost. (d) In case of Loan by Subsidiary to Parent - Treated as Dividend Distribution (e) In all other cases - Immediately transfer to P&L |
|---|--|

Subsequent Recognition:

Recognise Interest Income using same market rate (ERI) by unwinding the discounting rate in Profit and Loss a/c

| Year | Opening | Interest | Collection | Closing |
|------|---------|------------------|------------|---------|
| (1) | (2) | (3) = (2) x Rate | (4) | (2+3-4) |

Journal Entries:

- 1) Financial Assets A/c Dr.
 To Bank A/c

- 2) Financial Assets A/c Dr.
 To Finance Income A/c

- 3) Bank A/c Dr.
 To Financial Assets A/c

Types of Financial Assets at Amortised Cost**Case 1: Loan is Given at off Market Terms (Refer Practical Example 1)**

i.e. Contractual Rate is Higher or Lower than Market Interest Rate

- 1) ERI = Market Rate given in the Question
- 2) Initial Recognition of FA = PV of CCF inflows at Market Rate
- 3) Initial Gain/loss = Initial Outflow (-) PV of CCF

Financial Assets A/c Dr. (PV of CCF)
 To Bank A/c (Proceeds)
(Difference is Gain/loss transfer to P&L)

Case 2: Loan is given at Market Terms (Refer Practical Example 2)

i.e. Contractual Rate is almost equal to Market Interest Rate

- 1) ERI may not be given, it is to be calculated separately by Trial & Error technique.
 ERI is the rate at which Sum of PV of CCF should be equal to Initial Net Outflows
- 2) Initial Recognition of FA = Initial Outflows +/- Transaction Cost
- 3) Initial Gain/loss = Not Possible

Financial Assets A/c Dr. (Net Outflow)
 To Bank A/c (Net Outflow)

Financial Assets under Fair Value through OCI (FVTOCI)

Initial recognition:

- 1) Almost same as AMC category
- 2) However, Fair Value here could be ready made Market Value.
- 3) Transaction cost is added to the total initial outflow.

| | |
|--|--|
| <p>(Refer Practical Example 3 and 5)</p> | <p>Subsequent recognition:</p> <ol style="list-style-type: none"> 1) Income Received shall be recognised in Profit and Loss 2) Investment is re-measured at Fair Value and difference is transferred to OCI (Fair Value Reserve). <p>Treatment of Fair Value Reserve (OCI) on sale of Investment:</p> <ol style="list-style-type: none"> 1) Reclassified to Profit and loss a/c 2) Exception: When Investment in Equity shares are not held for trading and designated as FVTOCI, then transfer the OCI reserve directly to Retained Earnings. |
| <p>Financial Assets under Fair Value through P&L (FVTPL₹)</p> <p>(Refer Practical Example 4)</p> | <p>Initial recognition:</p> <ol style="list-style-type: none"> 1) Investment is recognised at Fair Value which is ready made market value. 2) Transaction cost is charged to Profit and loss a/c <p>Subsequent recognition:</p> <ol style="list-style-type: none"> 1) Income Received shall be recognised in Profit and Loss 2) Investment is re-measured at Fair Value and difference is transferred to P&L (Fair Value Gain/loss). |

2. FINANCIAL LIABILITIES

CLASSIFICATION OF FINANCIAL LIABILITIES:

| | |
|---|--|
| <p>Categories of Financial Liabilities</p> | <ol style="list-style-type: none"> 1) Financial Liabilities measured at Amortised Cost (AMC) 2) Financial Liabilities measured at Fair Value through P&L (FVTPL) |
| <p>Financial Liabilities measured at Amortised Cost (AMC)</p> | <p>Those liabilities where the obligation is to be pay all contractual cash flows are FL measured at AMC</p> <p>Examples - Loans, Debentures issued, Redeemable Preference shares etc.</p> <p>Financial Liabilities measured at AMC are further classified into two types:</p> <ol style="list-style-type: none"> 1) Non-compound Financial Instruments (Pure Liability no Equity) such as Bank Loans, Non-convertible debentures/bonds/preference shares 2) Compound Financial Instruments (FL and Equity Mix) such as Convertible Debentures and Preference shares. |
| <p>Financial Liabilities measured at FVTPL</p> | <p>Examples:</p> <ol style="list-style-type: none"> 1) Derivative Instruments |

2) Financial Guarantee Contracts

ACCOUNTING TREATMENT OF FINANCIAL LIABILITIES (AMC):

| | |
|---|--|
| <p style="text-align: center;">Non-Compound Financial Instruments (Pure FL)</p> <p>(Refer Practical Example 10)</p> | <p>Case 1: Loan is taken at off Market Terms i.e. Contractual Rate is Higher or Lower than Market Interest Rate</p> <ol style="list-style-type: none"> 1. ERI = Market Rate given in the Question 2. Initial Recognition of FL = PV of CCF outflows at Market Rate 3. Initial Gain/loss = Initial Proceeds (-) PV of CCF <p style="text-align: center;">Bank A/c Dr. (Proceeds) To Financial Liability A/c (PV of CCF) (Difference is Gain/loss transfer to P&L)</p> <p>Case 2: Loan is taken at Market Terms i.e. Contractual Rate is almost equal to Market Interest Rate</p> <ol style="list-style-type: none"> 1. ERI may not be given, it is to be calculated separately by Trial & Error technique. ERI is the rate at which Sum of PV of CCF should be equal to Initial Net Proceeds 2. Initial Recognition of FL = Initial Proceeds +/- Transaction Cost 3. Initial Gain/loss = Not Possible <p style="text-align: center;">Bank A/c Dr. (Net Proceeds) To Financial Liability A/c (Net Proceeds)</p> |
| <p style="text-align: center;">Compound Financial Instruments (Mix of FL & Equity)</p> <p>(Refer Practical Example 9)</p> | <p>Step 1: Financial Liability Component Calculate Financial Liability Component which is equal to PV of CCF (outflows) at Market Interest Rate (ERI)</p> <p>Step 2: Calculate Equity Component Total Net Proceeds Less Financial Liability Component</p> <p>Step 3: Allocation of Transaction cost Transaction Cost (if any) shall be allocated on FL Component and Equity Component in the ratio of above Steps</p> <p>Step 4: Recognised FL & Equity Component Now Recognise FL Component after deducting Allocated Transaction Cost and Recognise Equity Component after deducting Allocated Transaction Cost.</p> |

Step 5: Calculate Revised ERI

Because of Allocation of Transaction cost to FL Component, we have Recalculate ERI.

The rate at which Sum of PV of CCF outflows should be equal to initially recognised FL Component.

Step 6: Interest Cost

Calculate Interest Cost considering Revised ERI on FL Component for each year and measure the FL at Amortised cost at every year end. (Equity Component shall be carried at initially recognised amount only)

Step 7: Maturity DateCase A - Instrument is Redeemed in Cash

FL Component A/c Dr.
To Bank A/c

Equity Component A/c Dr.
To Retained Earnings

Case B - Instrument is Converted into Equity Shares

FL Component A/c Dr. (Carrying amount)
Equity Component A/c Dr. (Carrying amount)
To Equity Share Capital A/c (Face Value)
To Security Premium A/c (balancing fig.)

Financial Liability measured at FVTPL i.e. Financial Guarantee Contracts & Derivatives will be discussed later.

3. MODIFICATION IN FINANCIAL INSTRUMENTS

Modification may arise due to:

Early Redemption of Liability, Change in Repayment Terms, Change in Contractual Interest Rate, Change in Principal Repayment Terms etc. Following are different cases of Modification:

A. MODIFICATION IN FINANCIAL ASSETS

Cases of modification in FA are:

- a) Changes in Repayment Terms of Staff Loan
- b) Changes in terms of Security Deposits etc.

Following steps are required:

Step 1: Carrying Amount

Determine the carrying value of Financial Asset as on modification date.

Step 2: Revised Amount

Calculate Revised value of Financial Asset on modification date as per Revised Terms (Present Value of Revised Cash Flows using Revised ERI if available otherwise original ERI)

Step 3: Gain/loss due to Modification:

- Gain/loss due to modification of Staff Loan will be adjusted against Un-amortised Prepaid Employee Cost.
- Gain/loss due to modification of Security Deposits will be adjusted against Un-amortised Prepaid Lease Rent
- Gain/loss due to any other case will be transferred to Profit and Loss A/c

| Increase of Financial Asset | | Decrease of Financial Asset | |
|--------------------------------------|---------------|------------------------------|----------|
| Financial Asset A/c Dr. | (Gain Amount) | Profit and Loss A/c | Dr. (or) |
| To Profit and Loss A/c (or) | | Prepaid Employee Benefit A/c | Dr. (or) |
| To Prepaid Employee Benefit A/c (or) | | Prepaid Lease Rent Dr. A/c | Dr. |
| To Prepaid Lease Rent A/c | | To Financial Asset A/c | (Loss) |

Early Repayment of Any Installment of Financial Asset

Bank A/c Dr.
 To Financial Asset A/c (Difference of above Step 1 & Step 2)
 (Difference is charged as per Step 3 above)

(Refer Practical Example 13)

B. EARLY REDEMPTION OF COMPOUND FINANCIAL INSTRUMENTS

Early redemption means payment before actual maturity date. The payment shall be made as per the current market value. Following steps are required:

Step 1: Carrying Amount

Determine the carrying values of Financial Liability and Equity Component as on early redemption date.

Step 2: Revised Amount

Calculate Revised values of FL and Equity on early redemption date by allocating the amount of Consideration paid on early redemption date.

Revised FL Component = Present Value of Remaining Cash Flows using Revised Discount Rate

Revised Equity Component = Consideration to be Paid on Early Redemption (-) Revised FL Component

Step 3: Settlement Gain/loss

Recognise the gain or loss on settlement as under:

Gain/loss on settlement of FL Component in Profit and Loss A/c

Gain/loss on settlement of Equity Component directly in Other Equity (Retained Earnings)

| Settlement of FL Component | | Settlement of Equity Component | |
|-----------------------------|--------------------|--------------------------------|------------------------|
| Financial Liability A/c Dr. | (Carrying Amount) | Equity Component A/c Dr. | (Carrying Amount) |
| To Bank A/c | (Revised FL Comp.) | To Bank A/c | (Revised Equity Comp.) |

(Difference is charged to Profit and Loss)

(Difference is transferred to Retained Earnings)

C. MODIFICATION IN NON-COMPOUND FINANCIAL INSTRUMENTS

When there is change in Terms of Debt Instrument (Financial Liability) due to any reason, first of all we need to identify the percentage of such change, based on this accounting is done.

Step 1: Carrying Amount

Determine the carrying value of Financial Liability on the Modification date.

Step 2: Revised Amount as per Original ERI

Calculate Revised value of Financial Liability on the modification date with the help of revised terms taking original discounting rate (Original ERI)

Step 3: % of Change

$$\frac{\text{Difference of Step 1 and Step 2}}{\text{Step 1}} \times 100$$

Analysis

If % of change is 10% or More, apply **Extinguishment Accounting**

If % of change is less than 10%, apply **Modification Accounting**

| Extinguishment Accounting (10% or More) | Modification Accounting (less than 10%) |
|---|--|
| <ol style="list-style-type: none"> De-recognise the Existing Carrying amount of Financial Liability. Recognise New/Modified Financial Liability at Fair Value (net of any fees incurred) using Revised ERI given in the question. (Refer Example 11) If Revised ERI is not given, then recognise the new/modified liability at the Outstanding amount payable on the date of modification and calculate the ERI to be used in future for recording finance cost of every year. (refer Example 12) Difference of Carrying amount (which is de-recognised) and New/Modified Financial liability (which is recognised) is transfer to Profit and Loss immediately as Gain or Loss on Extinguishment. | <ol style="list-style-type: none"> Deduct Modification Fees/Cost from carrying amount of Financial Liability. Recalculate the ERI. It is a rate which PV of Revised CCF outflows will be equal to the carrying amount of FL after deduction of above fees/cost. Further Interest Cost shall be calculated using New ERI |
| Refer Practical Example 11 and 12 | |

D. DEBT FOR EQUITY SWAPS

It means the Financial Liability is settled by issuing the Equity shares. Apply following steps for accounting:

Step 1: De-recognise Carrying Amount of FL

Step 2: Recognise Equity Instrument (ESC & SP) at Fair Value. (Fair Value sometimes can be calculated with reference to Net Assets of Entity)

Step 3: Difference due to above adjustment is transfer to Profit and Loss A/c

| | |
|-----------------------------|----------------|
| Financial Liability A/c Dr. | (Carrying Amt) |
| To ESC & SP A/c | (Fair Value) |
| To Profit and Loss A/c | (Difference) |

(Refer Q704 of Question Bank)

4. FINANCIAL GUARANTEE CONTRACTS

- Entity (A Ltd.) guarantees to lender (HDFC Bank) to repay the borrowed amount if the borrower (B Ltd.) defaults.
- There may be a possibility that Entity (A Ltd.) is charging some fees from Borrower (B Ltd.) to provide a guarantee.
- Due to this guarantee the lender is providing Loan at concessional rate of interest (less than market rate).
- Here, Entity (A Ltd.) has to recognise Financial Guarantee Liability through FVTPL.

Apply following steps for accounting:

Step 1: Calculate the Fair Value of Financial Guarantee Liability as under:

| Interest @ Market Rate | Interest @ Concessional Rate | Saving of Interest | PV of Saving of Interest at Market Rate |
|------------------------|------------------------------|--------------------|---|
|------------------------|------------------------------|--------------------|---|

| | | |
|---------------------------|-----|-----------------------------------|
| Bank A/c | Dr. | (Amount Charged if any) |
| P&L A/c or Investment A/c | Dr. | (Difference) |
| | To | Financial Guarantee Liability A/c |

Note: Investment Account will be debited when Guarantor Entity is Parent company and Borrower is Subsidiary Co.

Step 2: Remeasure Financial Guarantee Liability at each Balance Sheet date at higher of:

- PV of remaining Interest Savings (Carrying Amount) or
- Expected Loss due to default by borrower (Loss Allowance)
 $\text{Loan Amount} \times \text{Probability of Default}$

Note: Transfer the difference if any to Profit and Loss Account (FVTPL)

Step 3: Settlement of Loan by Borrower with or without default:

| Settlement without default | Settlement with Default |
|---|--|
| Guarantor entity shall reverse Financial Guarantee liability: | If Borrower defaults, Guarantor entity shall pay the difference: |
| Financial Guarantee Liability A/c Dr. | Financial Guarantee Liability A/c Dr. |

| | |
|------------------------|---|
| To Profit and Loss A/c | To Bank A/c (Difference is transferred to P&L) |
|------------------------|---|

(Refer Practical Example 14)

5. LOAN BY PARENT TO SUBSIDIARY (at Free or Concessional Rate)

| | |
|---|--|
| <p>Case 1: Loan is repayable on demand</p> | <ul style="list-style-type: none"> • Fair Value will be the transaction value only • FA for Parent Co. and FL for Subsidiary Co. • Finance Income and Expense shall be calculated at Concessional Rate only if any. |
| <p>Case 2: Loan is for Fixed Term</p> | <ul style="list-style-type: none"> • Loan is FA (AMC) for Parent co. and FL (AMC) for Subsidiary and recognised at PV of CCF @ Market Rate. • Difference in the books of Parent co. is debited to Investment A/c. • Difference in the books of Subsidiary co. is credited to Other Equity (Equity Contribution A/c). • Investment A/c & Equity Contribution A/c will become offset under Consolidated Financial Statements • Finance Income and Expenses shall be recognised at Market Interest Rate. |
| <p>Case 3: Loan will be repayable when funds will be available with subsidiary</p> | <ul style="list-style-type: none"> • It is not treated as repayable on demand. • Both Parent and Subsidiary co. has to determine the expected repayment date and identify the nature of loan such Current or Non-current as apply required accounting accordingly. |
| <p>Case 4: Loan by Subsidiary to Parent</p> | <ul style="list-style-type: none"> • Both Parent and Subsidiary shall apply Amortised Cost Method (AMC). • Parent shall treat it as Financial Liability and Subsidiary shall treat it as Financial Asset • Difference is treated as Dividend Income for Parent and Dividend distribution for subsidiary. |

Refer Series 900 Questions for Practice.

6. IMPAIRMENT OF FINANCIAL ASSETS (Provision for Doubtful Debts or Loss Allowance)

1. Financial Assets measured at **Amortised Cost Method and FVTOCI** (except Equity Investment) are subject to Impairment.
2. Impairment loss (loss allowance) shall be calculated as per "**Expected Credit Loss**" (ECL) method.
3. Let's understand following elements first for ECL method:
 - (a) **Loss Given Default (LGD)** - Amount which is expected to be unrealized.
 - (b) **Probability of Default (POD)** - Chances of not paying the amount (i.e. Credit Risk).
 - (c) **12 Months ECL** - Expected unrealized cash flows for next 12 months
 - (d) **Lifetime ECL** - Expected unrealized cash flows for remaining term of loan.
 - (e) **FA is Credit Impaired** - Means FA is almost lost or there is remote chances of recovery.
4. How to calculate Impairment Loss:

| | |
|---|--|
| On Single Identified Financial Asset (Specific Basis) Refer Practical Example 15 | Method 1: Carrying Amount of Loan - XXX Less: PV of Estimated CCF to be realised - XXX Impairment Loss XXX Method 2: Carrying Amount of Loan X LGD % X POD % |
| On Portfolio of Financial Assets (General basis) Refer Practical Example 16 | Apply 12 Month ECL on FA having low credit risk: Carrying Amount of all FA X LCD of next 12 Month X POD of next 12 Month Apply Lifetime ECL on FA if credit risk is Moderate or High or on Short Term FA such as debtors: Carrying Amount of all FA X LCD of Lifetime ECL X POD of Lifetime ECL |
| Journal Entries: | Impairment Loss (P&L) Dr. To Loss Allowance A/c (Loss allowance means provision for doubtful debts) Once FA is Credit Impairment (i.e. lost): Loss allowance A/c Dr. Profit and Loss A/c Dr. (bal. fig.) To Financial Assets A/c (Carrying Amt.) |

5. Recognition of **Interest Income** on Financial Assets impaired during the year:

| | |
|---|---|
| <ul style="list-style-type: none"> FA under 12 Months ECL and FA under Lifetime ECL with Moderate Credit Risk | Interest is calculated on Gross Value of Financial Assets (without deducting loss allowance amount) |
| If FA is credit impaired or there is significant credit risk | Interest is calculated on Net Value (i.e. after deducting loss allowance from carrying amount of FA) |

7. DERECOGNITION OF FINANCIAL ASSETS & FINANCIAL LIABILITIES

Derecognition means removing a financial asset or liability from the balance sheet.

- Derecognition of Financial Liabilities:** This was already discussed under Modification accounting in the form of Early redemption, debt for equity swap, Extinguishment. Any Difference arise due to derecognition of Financial Liabilities is transfer to profit and loss.
- Derecognition of Financial Assets:** Derecognition of Financial Assets occurs when contractual cash flows are expired (or) on transfer of contractual cash flows (i.e. sale of FA):

| | |
|---|---|
| FA under FVTOCI | On derecognition, accumulated balance in OCI is reclassified to profit and loss. Exception: in case of Equity Investment Not Held for Trading , accumulated OCI balance is transferred to retained earnings. |
| Transfer of Cash flows without transfer of risks and rewards | When FA is transferred without transfer of risks and rewards then such FA is not derecognized. Any Proceeds received is treated as Loan (FL). |
| Types of Derecognition | <ol style="list-style-type: none"> Full derecognition - All Cash Flows are transferred. Partial derecognition - Some portion of Cash Flows are transferred. |
| Full derecognition | Bank A/c Dr. (Proceeds of Sale) To Financial Assets A/c (Carrying Amount) (Difference is transferred to Profit and Loss) |
| Types of Partial derecognition | <ol style="list-style-type: none"> Securitization of Loans (FA) Factoring of Debtors |
| Securitization of Loans Refer Practical Example 18 | Transfer of Right to receive some of the cash flows such as right to receive interest only or principal only or part of interest and principal only is transferred. Here, Financial Asset is divided into following components: <ol style="list-style-type: none"> Securitized Component (Transferred portion) Retained Principal Component Retained Interest Component |

d) Retained Service Asset

Follow these steps for accounting:

Step 1: Identify the Fair Values of all Components (given in the question) if not given then calculate the Fair values as - PV of Future Cash Flows at ERI

Step 2: Allocate the Total Carrying Amount of Loan (FA) into above components (in the ratio of fair values)

Step 3: Derecognize the total carrying amount of Loan and recognise the individual components

| | | |
|----------------------------------|-----|-----------------|
| Securitized Loan Component A/c | Dr. | |
| Retained Principal Component A/c | Dr. | |
| Retained Interest Component A/c | Dr. | |
| Service Component A/c | Dr. | |
| To Loan A/c | | (Carrying Amt.) |

Step 4: Sale of Securitized Component

| | | |
|------------------------------|---------------------|-----------------|
| Bank A/c | Dr. (Sale Proceeds) | |
| To Securitized Component A/c | | (Carrying Amt.) |

(Difference is transfer to P&L)

Factoring of Debtors (with Full Recourse)

Here full recourse means transfer of right to receive cash flows without transfer of risk of bad debts.

Consideration received from Factor Agent is treated as Loan Liability (FL) under AMC category.

If the factor agent is unable to collect some of the cash flows, Investor entity shall recognise the loss of bad debts.

Factoring of Debtors (with Partial Recourse)

Partial Recourse means transfer of right to receive some portion of cash flows and retaining some portion.

Investor has some involvement in Financial Asset transferred.

Apply following steps:

Step 1: Calculate loss on derecognition of FA

Carrying Amt of FA (-) Proceeds collected

| | | |
|---------------------------|-----|-----------------|
| Bank A/c | Dr. | (Proceeds) |
| Loss on Derecognition A/c | Dr. | (difference) |
| To Loan (FA) A/c | | (Carrying Amt.) |

Step 2: Recognise Continuing Involvement in FA A/c as an Asset

That part of loan whose risk of bad debt is not transferred to factoring agent and entity has right to collect if not recovered by agent:

Continuing Involvement Asset A/c Dr.

To Associated Liability A/c

Associated Liability means - if bad debt occurs on such portion whose risk is not transferred to factoring agent, then entity has to reimburse the amount to agent.

Step 3: Recognise Expected ultimate bad debts whose risk is not transferred, and entity expects that it will never recover:

Loss on Derecognition A/c (Expected Bad debts)
To Provision for Loss allowance A/c

Note: Combined Entry can also be passed as under:

| | | |
|----------------------------------|-----------------------------|-------------------|
| Bank A/c | Dr. | (Proceeds) |
| Loss on Derecognition A/c | Dr. | (Step 1 + Step 3) |
| Continuing Involvement Asset A/c | Dr. | (Step 2) |
| | To Loan (FA) A/c | (Carrying Amt.) |
| | To Associated Liability A/c | (Step 2 + Step 3) |

Example 1: (Risk is not transferred)

Investor is holding equity shares of another entity at Rs. 1,00,000/- & sold it at Rs. 1,25,000 with following Conditions.

Case 1: Investor shall repurchase FA after 6 months @1,50,000/-

Investor has not passed control to buyer since it is obliged to repurchase after 6 months it is already a financing arrangement. No Derecognition shall be made.

| | | | |
|------------------|-----|----------|----------|
| Bank A/c | Dr. | 1,25,000 | |
| To Loan (FL) A/c | | | 1,25,000 |

After 6 Month

| | | | |
|---------------|-----|----------|----------|
| Loan (FL) A/c | Dr. | 1,25,000 | |
| Interest A/c | Dr. | 25,000 | |
| To Bank A/c | | | 1,50,000 |

Case 2: Investor has given a put option to Buyer to sell these FA back to Investor after 6 months at 2,00,000/-

Investor lost the control. Hence, Derecognition shall be made.

| | | | |
|-------------|-----|----------|----------|
| Bank A/c | Dr. | 1,25,000 | |
| To FA A/c | | | 1,00,000 |
| To Gain A/c | | | 25,000 |

Example 2:

Jai Ltd. the owner having debtors of 50,00,000/- transferred the right to Mansi Ltd. (Factor) to receive a cash for 48,00,000/-

In the books of Jai Ltd.

- 1) Debtors will be continued @50,00,000

2) Amount Received shall be treated as Financial liability:

| | | | |
|----------------------------|-----|-----------|-----------|
| Bank A/c | Dr. | 48,00,000 | |
| To Financial Liability A/c | | | 48,00,000 |

3) Case 1: Factor recovered full 50 Lakhs from Debtors:

| | | | |
|-------------------------|-----|-----------|-----------|
| Financial Liability A/c | Dr. | 48,00,000 | |
| Loss A/c | Dr. | 2,00,000 | |
| To Debtors A/c | | | 50,00,000 |

4) Case 2: Factor Recovered 49 Lakhs

| | | | |
|--|-----|-----------|-----------|
| Financial Liability A/c | Dr. | 48,00,000 | |
| Loss A/c | Dr. | 2,00,000 | |
| To Debtors A/c | | | 49,00,000 |
| To Bank A/c | | | 1,00,000 |
| (Jai will recover remaining 100000 from Debtors) | | | |

Suppose Jai Ltd. recovered 80000 only:

| | | | |
|----------------|-----|--------|----------|
| Bank A/c | Dr. | 80,000 | |
| Loss A/c | Dr. | 20,000 | |
| To Debtors A/c | | | 1,00,000 |

5) Case 3: Factor Couldn't recover any amount

| | | |
|---|----|----|
| Bank A/c Dr. | 48 | |
| To Financial Liability A/c | | 48 |
| Financial Liability A/c Dr. | 48 | |
| Loss A/c Dr. | 2 | |
| To Bank A/c | | 50 |
| Now we have 100% involvement in our Financial Asset and we tried to recover 40 Lacs: | | |
| Bank A/c Dr. | 40 | |
| Loss A/c Dr. | 10 | |
| To Debtors A/c | | 50 |

Example 3: -

An Entity (Bank) has 100 lakhs of Loan Assets and these are assigned to a factoring asset at 94 lakhs Cash. With recourse of a maximum of 5 lakhs of Bad-debts.

Expected Bad-debts of Rs. 2,00,000 may occur.

Journal Entries:

Full Derecognition:

| | | | |
|--|-----|----------|-----------|
| 1) Bank A/c | Dr. | 94 Lakhs | |
| Loss on Derecognition (FA) A/c | Dr. | 6 Lakhs | |
| To Loan Assets A/c | | | 100 Lakhs |
| 2) Continuing involvement in Asset A/c | Dr. | 5 Lakhs | |
| To Associated Liability A/c | | | 5 Lakhs |

(Continuing involvement in Asset means - if Bad Debts occur we will be entitled to recover to the extent of 5 Lakhs directly from debtors) and (Associated Liability means - if bad debts occur we have to pay it to Factoring Agent)

| | | | | |
|----|--|-----|---------|---------|
| 3) | Loss on Derecognition A/c | Dr. | 2 Lakhs | |
| | To Provision for Associate Liability A/c | | | 2 Lakhs |

Combined entry (Alternate):

| | | | |
|-------------------------------------|-----|----------|-----------|
| Bank A/c | Dr. | 94 lakhs | |
| Continuing involvement in Asset A/c | Dr. | 5 lakhs | |
| Loss on Derecognition A/c | Dr. | 8 lakhs | |
| To loan Asset A/c | | | 100 lakhs |
| To Associate Liability A/c | | | 7 lakhs |

Example 4: -

An entity has loan assets of 80 lakhs & entered into a factoring agreement @75 lakhs with recourse up to a max. of

Case 1: Nil (All rights and risks are transferred)

Case 2: 75 lakhs (substantial Rights & Risks are not transferred Hence, No Derecognition)

Case 3: 15 lakhs (Substantial Rights & Risk neither retained nor transferred), Expected Bad debts are 2.5 Lacs (i.e. FV of guarantee)

Solution:

Case 1:

| | | | |
|-------------------|-----|----------|----------|
| Bank A/c | Dr. | 75 lakhs | |
| Loss A/c | Dr. | 5 lakhs | |
| To Loan Asset A/c | | | 80 lakhs |

Case 2:

| | | | |
|------------------------------|-----|----------|----------|
| Bank A/c | Dr. | 75 lakhs | |
| To Financial Liabilities A/c | | | 75 lakhs |

Case 3:

| | | | |
|-------------------------------|-----|-----------|------------|
| Bank A/c | Dr. | 75 lakhs | |
| Continuous Involvement A/c | Dr. | 15 lakhs | |
| Profit & Loss A/c | Dr. | 7.5 lakhs | |
| To Loan Asset A/c | | | 80 lakhs |
| To Associated Liabilities A/c | | | 17.5 lakhs |

8. MISCELLANEOUS PROVISIONS

A. TRADE DATE ACCOUNTING VS. SETTLEMENT DATE ACCOUNTING

1. Entities may choose either Trade date accounting or Settlement date accounting for Financial Instruments.
2. Trade date accounting - FA/FL shall be recorded on agreement date itself although the transaction is yet to be settled in future.
3. Settlement date accounting - FA/FL shall be recorded on final settlement date only and ignoring trade date.
4. On Balance sheet date, while measuring asset/liability at fair value -
Trade date accounting - FA/FL shall be increased/decreased accordingly
Settlement date accounting - Changes in Fair value of FA/FL shall be recorded only without recording any FA/FL
5. The most important thing to understand is whether we are following Trade date accounting or settlement date accounting, FA/FL shall be shown at Fair Value on Settlement date.

B. PUTTABLE EQUITY SHARES & TREASURY SHARES

1. Puttable equity shares are the type of equity that gives the shareholders **the right** (not the obligation) **to sell the shares to the issuing company** at a specified price.
2. Treasury shares (stock) are shares that were once part of company's outstanding shares but were later **repurchased by the company (bought back)**. These shares are either cancelled by the company or held by the company itself until the company decides what to do with them and **are not considered while distributing dividends and calculating EPS**.
3. Treatment of Puttable and Treasury shares is almost same and both are **treated as Financial Liability** when announced by the company.
4. Any amount charged by the company (often called as premium) to issue puttable shares or to give an option to repurchase treasury shares is transferred to **Other Equity (not in P&L)**.
5. Following journal entries may be passed:

| | |
|---|---|
| On receipt of premium to convert non-puttable equity to puttable equity or to repurchase treasury shares | Bank A/c Dr. To Premium (Other Equity) A/c |
| Creating Financial liability | Equity shares (Non-puttable) A/c Dr. To Financial Liability A/c (at Fair Value) This financial liability can be treated under AMC |
| Charging of Interest on FL (AMC) when payable beyond 12 months | Finance Cost (P&L) A/c Dr. To Financial Liability A/c |

| | |
|-----------------|---|
| Settlement Date | <u>If option is exercised by holders:</u> Financial Liability A/c Dr. To Bank A/c |
| | <u>If option is not exercised (Lapsed):</u> Financial Liability A/c Dr. (Carrying Amt.) To Equity A/c |

C. RECLASSIFICATION OF FINANCIAL ASSETS

Financial Assets can be re-classified from one category to another due to change in intention of entity to hold financial assets:

| | To Amortised Cost Method | To FVTOCI | To FVTPL |
|--------------------|--|---|---|
| From AMC | - | Measured at Fair Value on reclassification date and difference is transferred to OCI. | Measured at Fair Value on reclassification date and difference is transferred to P&L. |
| From FVTOCI | Measure at Amortised cost. Cumulative OCI Gain/Loss is reversed to Financial Asset A/c | - | Measured at Fair Value on reclassification date and difference is transferred to P&L. Cumulative OCI Gain/loss is reclassified to P&L. |
| From FVTPL | Measure at Fair Value on reclassification date. It becomes a new gross carrying amount and difference is transferred to P&L. ERI is calculated based on New Carrying Amount. | Measured at Fair Value on reclassification date and difference is transferred to P&L. | - |

Note: Equity investment (not held for trading) designated under FVTOCI can never be reclassified to FVTPL.

UNIT - 3

DERIVATIVES & HEDGE ACCOUNTING

1. MEANING OF DERIVATIVES

- 1) A derivative contract is a contract between two parties to buy/sell any underlying asset on future date at specified price.
- 2) Underlying Asset can be equity shares, stock index such as Nifty, Foreign Exchange rates, Interest rates, any commodity such as Gold etc.
- 3) Derivative contracts have following characteristics:
 - a. Its value changes in response to change in an underlying.
 - b. It requires no investment or very little initial investment (in the form of Premium or Margin Money).
 - c. It is settled at a future date.
 - d. It is generally settled on Net Basis (i.e. in cash without any physical delivery).

Note: However, derivative contracts in the question will be settled either in cash or in physical delivery also.

Example 5:

PQR Ltd. issues a call option (i.e. an option to buy) to ABC Ltd. to subscribe to PQR Ltd.'s equity shares at a price of Rs. 100 per share. The call option is to be settled on a 'net' basis i.e. without physical delivery of shares. If at the balance sheet date, the market value of equity share of PQR Ltd. is Rs. 110 per share, PQR Ltd. will be obliged to pay Rs. 10 to settle the option. Such a condition is potentially unfavorable to PQR Ltd. and hence Rs. 10 represents a financial liability for PQR Ltd.

2. MEASUREMENT & ACCOUNTING OF DERIVATIVES

- (i) Derivatives are always measured at Fair Value and accounted under FVTPL category, except derivatives that qualify as hedging instruments.
- (ii) **Time of Recognition of Derivative Contracts:** Generally, all derivative contracts are recognised on balance sheet at Fair Value based on favorable position (Financial Asset) or unfavorable position (Financial Liability).
- (iii) However, derivative contracts can be recognised on the date of contract also when some premium is paid or received, and it is expected:
 - to be recovered in future (paid earlier), then record Financial Asset initially
 - to be paid in future (received earlier), then record Financial Liability initially.
- (iv) Fair value means "EXIT PRICE" i.e. if such derivative contract is settled on balance sheet date then what would be the price which entity may receive or pay.

OPTION CONTRACTS

- (i) Under Option contracts there are two parties:
 Option Holder: who has the right to buy or right to sell the underlying.
 Option Writer: who has obligation to sell (if holder opts for buy) or obligation to purchase (if holder opts for sell)
- (ii) Option holder pays premium to option writer.
- (iii) Option holder pays premium to buy Call Option (i.e. Right to buy) or to buy Put Option (i.e. Right to sell)
- (iv) These contracts are entered into with the help of Exchange.
- (v) They have defined Underlying, defined Term and defined lot Size.
- (vi) Accounting in the books of Holder and Writer is below:

| Option Holder | Option Writer |
|---|---|
| <u>When to Exercise the Option by Holder?</u> Call Option - When market price is higher Put Option - When market price is lower | |
| Day 1: Payment of Premium This Premium is transfer to Profit and Loss immediately as an Expense. Option Premium Exp. A/c Dr. To Bank A/c | Day 1: Receipt of Premium This Premium is transfer to Profit and Loss immediately as an Income. Bank A/c Dr. To Option Premium Income A/c |
| On B/S date: Check Position If Favorable: Derivate Option Asset A/c Dr. To Fair Value Gain (P&L) A/c | On B/S date: Check Position If Unfavorable for writer: Fair Value Loss (P&L) A/c Dr. To Derivate Option Liability A/c |
| If Unfavorable: Do Nothing, premium already paid is not refundable. | If Favorable for writer: Do Nothing, Holder will not exercise the option. The premium already received is not refundable. |
| Settlement Date: <u>If position is still favorable:</u> Bank A/c Dr. (Proceeds on net settlement) To Derivative Option Asset A/c (difference transfer to P&L) | Settlement Date: <u>If position is still Unfavorable:</u> Derivative Option Liability A/c Dr. To Bank A/c Dr. (Net Settlement) (difference transfer to P&L) |
| <u>If position not favorable, reverse the Asset:</u> FV Loss (P&L) A/c Dr. To Derivative Option Asset A/c | <u>If position is favorable, reverse the Liability:</u> Derivative Option Liability A/c Dr. To FV Loss (P&L) A/c Dr. |

Step 2: on Balance Sheet Date, check whether the entity is in favorable position or unfavorable position and create Financial Asset Receivable a/c or Financial Liability Payable a/c accordingly by the net gain in interest swaps.

Step 3: on settlement date, re-measure the Financial Asset or Liability based on position on settlement date and then realise the Financial Asset or settle the financial liability in Cash.

Prepaid Interest Rate Swaps:

If interest rate swap contract is in the nature of "Pay variable, get fixed rate" and it is prepaid (i.e. Initially Entire amount of Interest is paid), **then these are not derivative contracts**, since the initial investment on these are **not nil or very less**.

Example 7:

Loan from SBI @ 10% fixed. ICICI giving service of Floating rate. Interest is due at Quarter end.

Solution:

Q1 ending: Suppose Floating Rate = 9%

Borrower has favorable condition. ICICI will reimburse 1% to Borrower

Books of Borrower

| | |
|--|--------------------------|
| Derivative Swap (FA) Dr. To FV Gain (P&L) A/c (Amount Receivable from ICICI) | 1% Amount 1% Amount |
| Bank a/c Dr. To Derivative Swaps (FA) A/c | 1% Amount 1% Amount |
| Interest Exp. a/c Dr. To Bank a/c (Payable to SBI) | 10% Amount 10% Amount |

Q2 ending: Suppose Floating Rate = 10.8%

Borrower has un-favorable condition. Borrower must pay to ICICI @ 0.8%

Books of Borrower

| | |
|--|------------------------------|
| Fair Value Loss (P&L) Dr. To Derivative Swaps (F/L) A/c | 0.8 % Amount 0.8 % Amount |
| Derivative Swap D/c Dr. To Bank A/c | 0.8% Amount 0.8% Amount |
| Interest Exp. A/c Dr. To Bank A/c (Payable to SBI) | 10% Amount 10% Amount |

4. HEDGE ACCOUNTING

Hedging means - Managing Risk or reducing risk in a:

- Recognised Asset/Liability (such as Foreign Currency Debtors or Loans); or
- Firm commitment to buy an Asset (To buy Machine in Foreign Currency in Future); or
- Highly forecast cash flow transaction (To Invest Foreign Currency in Future)

by entering into a derivative contract in such a way that change in Fair value of Hedging Instrument wholly or partially **offset** change in Fair value of Hedged Item.

Some Important Terms:

- (a) **Hedged item** - It is already recognised Asset or Liability (such as Foreign Currency Debtors/Creditors, Loans etc), or a firm commitment to buy asset or a Highly probable Forecast Transaction which involves cash flows.
- (b) **Hedging instrument** - It is an investment in Derivative instrument such as (Futures, Forwards, Options).
- (c) **Firm Commitment:** A firm commitment is a binding agreement to buy/sell any Asset at specified future date.
- (d) **Highly Forecast Cash Flow Transaction:** A forecast transaction is an uncommitted but anticipated future transaction which involves cash inflow or outflow.

Types of Hedge Contracts:

- 1) Cash Flow Hedge
- 2) Fair Value Hedge
- 3) Hedge of Net Investment in Foreign Operations.

CASH FLOW HEDGE

Hedge contract to **protect Future Cash flows** on settlement of any Financial Asset or Liability such as Foreign Debtors, Creditor and Loans.

Accounting Treatment

Step 1 - Fair value the Hedged Item (debtors/creditor/loans) through OCI in the name of Cash Flow hedge reserve (CFHR A/c).

Suppose there is foreign currency loan liability and foreign currency value is increased, following entry will be passed:

Cash flow hedge Reserve A/c Dr.
To Loan Liability A/c

Step 2 - Fair value the hedging instruments (derivative contract) through OCI in the name of Cash Flow hedge reserve (CFHR A/c).

To protect cash outflow of above loan or to reduce loss due to change in currency rates, suppose we entered into Currency Forwards (Long Position), following entry will be passed:

Derivative Forwards Asset A/c Dr.

To Cash Flow Hedge Reserve A/c

Step 3 - Amortize the actual loss (Actual loss = Actual Transaction Price - Forward Contract Value) over the life of contract by debiting Profit and Loss a/c and crediting Cash Flow Hedge Reserve (OCI)

Profit and Loss A/c Dr.

To Cash Flow Hedge Reserve A/c

Step 4 - On settlement date, realise or settle the contract in cash. CFHR A/c account will be nil.

Loan Liability A/c Dr. (Carrying Amount)

To Derivative Forwards Asset A/c

To Bank A/c (actual outflow)

FAIR VALUE HEDGE

- When there is a risk on Hedged item **being other than Cash** such as Inventory, Gold, Shares of another co. held as investments and objective is to protect the fair value of such asset then fair value hedging is done.
- Under Fair value hedge, entity covers the risk by entering into hedging derivative contract in Futures, Forwards or Options.
- Accounting Treatment:
Both the Hedged Items and Hedging Instrument are measured **at Fair Value through Profit and Loss a/c.**

HEDGE OF NET INVESTMENT IN FOREIGN OPERATION

1) A hedge of a "Net Investment in Foreign Operation" is a way for a company **to protect itself from the risk of changes in exchange rates** when it has "investment in foreign subsidiary".

2) Example:

- An Indian Entity has Investment in US Subsidiary
- US Subsidiary operates in foreign Currency (Dollar) but Indian Entity operates in INR.
- If Dollar weakens against Indian rupee, the value of Investment in US Business will become low when it will be converted to INR. This will effect the Financial Position of Indian Entity badly.
- To avoid this risk, Indian Entity will enter into use Hedging in the form of taking loan in dollar to protect the value of investment from currency fluctuations.

3) Accounting:

- Investment in Foreign Subsidiary (Hedged Item) will create foreign currency translation difference (loss) due to decrease in Dollar rate. Such difference is transferred to **FCTR (OCI) as per Ind AS 21.**
- Foreign Currency Loan (hedged instrument) Value will also decrease due to decrease in Dollar rate and **transfer the profit to FCTR (OCI) to the extent of above loss (effective portion).**
- The remaining portion of profit (**ineffective portion**) is transferred to P&L immediately.
- When investment in foreign subsidiaries is disposed, accumulated gains and losses appearing in **FCTR (OCI) are reclassified to Profit and Loss A/c.**

5. EMBEDDED DERIVATIVES

- 1) Embedded means attached with some other non-derivate part.
- 2) Any contract which has Two Elements, one is **Host Contract** (i.e. main contract) which is non-derivative part of the contract, and the other one is derivative part (it is embedded with the host contract).

Examples of Embedded Derivatives:

1. Company ABC Ltd. enters into a lease with an inflation factor, such that each year rentals are adjusted for changes in risk price index. The hybrid contract is the entire lease; the host is the lease contract; the embedded derivative is the adjustment to the risk price index.
2. Company PQR Ltd. sells furniture to Company XYZ Ltd. in USD. Both companies are located in India. The hybrid contract is the entire sale contract which will be settled in USD; the host contract is the Rupee sale contract; the embedded derivative is the foreign exchange Rs/USD forward.

- 3) Accounting for Embedded derivative is required only when Host Contract and Embedded derivative are not closely related to each other and they are capable of being separate with each other.
- 4) **Accounting of Embedded Derivatives when separation is required:**

(a) Contract of Sell/purchase in future in Foreign Currency:

- Record the sale/purchase:
 - At the time of actual delivery
 - At pre-determined forward rate (forward rate on the date of contract)
- Recognise Derivative Asset or Liability at Fair Value
Fair Value is the difference between Value of Forward Contract at BS date and Value of forward contract on the date of contact.

(b) Prepayment option in Loan:

Here, prepayment option can be treated as embedded derivative and not closely related if prepayment amount is not approximately equal to the carrying amount of loan.

Step 1: Calculate value of Loan as per Amortised Cost Method

Step 2: Calculate value of Loan as per ACM if prepayment option is exercised.

Step 3: If difference in above two values is significant then Embedded derivative is not Closely related to Host Contract.



Student Notes:-

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

1. ACCOUNTING POLICIES

Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

Examples: Measurement basis of PPE as per Cost Model or Revaluation Model, Measurement of Cost of Inventory FIFO, W. Avg. etc.

Selection and Application of Accounting Policies

When an Ind AS specifically applies to a transaction or event, the accounting policy or policies applied to that item shall be determined by applying that particular Ind AS.

In the absence of an Ind AS that specifically applies to a transaction or event, **management shall use its judgement in developing and applying an accounting policy** along with following sources in the descending order:

- (a) Any other Ind AS dealing with similar and related issues;
- (b) The Framework of Ind AS
- (c) Most Recent pronouncement of International Accounting Standards Board (IASB) or any other standard setting bodies
- (d) Accepted Industry practices.

Consistency of Accounting Policies

An entity shall select and apply its accounting policies consistently for similar transactions and events, unless an Ind AS specifically requires or permits categorisation of items for which different policies may be appropriate.

Changes in Accounting Policies

- An entity shall change an accounting policy only if the change:
 - (a) Is required by an Ind AS; or
 - (b) Results in providing **reliable and more relevant information** on the entity's financial position, financial performance or cash flows.

The following are not change in Accounting Policies:

- (a) The application of an accounting policy for transactions and events **that differ in substance** from those previously occurring;
Example: Cost Model for Investment Property and Revaluation Model for PPE

- (b) The application of a new accounting policy for transactions and events **that did not occur previously or were immaterial**. Example: Measurement of different Inventory product at FIFO.

How to apply the Changes in Accounting Policies?

While discussing the process for application of changes of accounting policies, Ind AS 8, bifurcates it into two situations.

1. If the change in accounting policy is due to new Ind AS, then generally **the standard itself will provide the guidance** for implementation. In such cases the company needs to follow the guidelines and implement the provisions accordingly.
2. If the change in accounting policy is made **voluntarily** or where the **Ind AS is not clearly setting up any guidelines** clearly for transitional period, then the accounting policy needs to be applied **retrospectively**.

Retrospective Application

- a) Adjust the comparative amounts of Previous year.
- b) **Adjust the Opening Balances** of Assets and Liabilities of **Previous year** for effects of changes in accounting policy and **difference is transferred to retained earnings**.
- c) If it is impracticable to follow retrospective application (means entity is not able to apply new accounting policy retrospectively with reasonable efforts), then entity should apply accounting policy prospectively.
- d) **Disclosures:** following disclosures are required in notes to accounts
 - (i) Nature of change in accounting policy
 - (ii) Effects of such change in current year and previous year (Amount)
 - (iii) If it is impracticable to apply retrospectively, then disclose the reasons.

Example 1:

An entity changes in 20X6 its accounting policy with respect to determination of cost of its inventories from FIFO to weighted average cost formula. This change is made because management believes that weighted average cost formula results in better matching of cost with revenue. Further, weighted average cost formula is generally used by other entities whose business is similar to that of the entity and, hence, provides reliable and more relevant information to the users of the financial statements. This being a voluntary change, it has to be applied retrospectively. The entity had commenced operations in 20X1. No records of earlier years are available as a virus attack on server in 20X6 had wiped off all past records. It is not possible to recreate the records. It is therefore impracticable to determine the cumulative effect of change in policy at the beginning of 20X6. The entity will apply the change in accounting policy prospectively from 20X6 only. Since the change in policy is applied prospectively from 20X6, the question of adjusting comparative information for any prior period(s) presented does not arise at all. Cost of closing inventories for 20X6 alone will be determined using weighted average cost formula. The carrying amount of closing inventories for 20X5 will simply be carried as carrying amount of opening inventories for 20X6. Cost of closing inventories for 20X5 determined on FIFO basis will be the starting point for applying weighted average cost formula during 20X6.

2. CHANGES IN ACCOUNTING ESTIMATES

Meaning

- As a result of the uncertainties inherent in business activities, many items in financial statements cannot be measured with accuracy but can only be estimated.
- Estimation involves **judgements** based on the latest available, reliable information. For example, estimates may be required for:
 - ❖ Bad debts;
 - ❖ Inventory obsolescence;
 - ❖ The fair value of financial assets or financial liabilities;
 - ❖ The useful lives of, or expected pattern of consumption of the future economic benefits depreciable assets; and
 - ❖ Warranty obligations.

Accounting Treatment for a Change in the Estimates

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.

Disclosure of changes in estimates

- An entity shall disclose **the nature and amount of a change** in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods.
- If the amount of the effect in future periods is not disclosed because estimating it is **impracticable**, **an entity shall disclose that fact**.

Change in Accounting Policy vs. Change in Accounting Estimates

When it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a **change in an accounting estimate**.

Example 2:

A change in the estimate of the amount of bad debt affects only the current period's profit or loss and therefore is recognised in the current period.

However, a change in the estimated useful life of, or the expected pattern of consumption of the future economic benefits in, a depreciable asset affects depreciation expense for the current period and for each future period during the asset's remaining useful life. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods is recognised as income or expense in those future periods.

Example 3:

A new retail entity provides for warranty obligation 2% of its sales. After being in trade for 3 years because of its stringent quality control processes, the actual warranty obligations is at 1%. It has now revised and provides for warranty obligations @ 1%. It is a change in accounting estimate.

3. ERRORS

Meaning:

- As per the definition given in Ind AS 8, Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information.
- Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

Example 4:

The following arithmetical error occurred in preparation of A Limited financial statement of immediately preceding financial year - (a) Depreciation on plant and machinery understated by an amount equal to 0.30% of sales; (b) Warranty provisions understated by an amount equal to 0.15% of sales; (c) Allowance for bad debts understated by an amount of 0.25% of sales. Individually none of these errors may be material but could collectively influence the economic decision of the users of the financial statements. These are material prior period errors.

Treatment of Errors:

- Rectify the error retrospectively from earliest prior period presented i.e. from the beginning of previous year and transfer the difference to retained earnings.
- If it is impractical to rectify the error retrospectively, then entity should restate the items of assets and liabilities prospectively.

Example 5:

While preparing the financial statement for the F.Y. 20X2-20X3, the latest prior period presented would be F.Y. 20X1-20X2. If the mistake is discovered for the year 20X1-20X2, then it will be rectified, immediately while presenting the statements for the year 20X2-20X3.

Example 6:

While preparing the financial statements for the F.Y. 20X4-20X5, if the mistake has been discovered for the year 20X1-20X2, i.e., for the period which was earlier than the latest prior period presented, then the corrected opening balances as on 1st April 20X3 of equities, assets and liabilities will be restated.

Disclosure of Prior Period Errors

An entity shall disclose the following:

- (a) **The nature** of the prior period error;
- (b) If practicable, the **amount of correction** for each prior period presented, item by item and also its impact on EPS.
- (c) The amount of the correction made in opening balances of comparative period.
- (d) If retrospective restatement is impracticable, disclose the reasons and from which date it is rectified.



Student Notes:-

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IND AS 10 – EVENTS AFTER THE REPORTING PERIOD

QUOTE:

Keep Going, Difficult Roads Can Lead to Beautiful Destination

1. MEANING OF EVENTS AFTER THE REPORTING PERIOD

Events (favorable or unfavorable) after the reporting period are the period between **the end of the reporting period and the date when the financial statements are approved.**

Example:

On 18th May,20X2, the management of an entity approves financial statements for issue to its supervisory board. The supervisory board is made up solely of non-executives and may include representatives of employees and other outside interests. The supervisory board approves the financial statements on 26th May,20X2. The financial statements are made available to shareholders and others on 1st June,20X2. The shareholders approve the financial statements at their annual meeting on 15th July,20X2 and the financial statements are then filed with a regulatory body on 17th July,20X2. The financial statements are approved for issue on 18th May,20X2 (date of management approval for issue to the supervisory board).

2. TYPES OF EVENTS AND THEIR TREATMENT

| ADJUSTING EVENTS | NON-ADJUSTING EVENTS |
|---|---|
| Events which provide evidence of conditions that existing on balance sheet date. | <i>Events that are Indicative of conditions that arose after the reporting period.</i> The events not related to circumstances/conditions existed on Balance sheet date; in other words, entirely new events after the BS date. |
| <u>Examples:</u> <ol style="list-style-type: none"> 1. Debtor declared insolvent after long outstanding receivable. 2. Settlement of litigation after balance sheet date (litigation started before balance sheet date) 3. Detection of fraud or error after balance sheet date. 4. Asset sold before balance sheet, consideration received after balance sheet date. | <u>Examples:</u> <ol style="list-style-type: none"> 1. Decline in the fair value of investments after the Balance Sheet. 2. Destruction of Assets of the entity by floods occurring after the reporting period. 3. Negotiation to purchase Property initiated before balance sheet date but actual transaction completed after balance sheet date. |
| Adjust the Assets/Liabilities of Financial Statement is ended. | No need to adjust the Assets/liabilities of financial statements. Only disclosure is required in case of material event. |

Example on Inventory

Entity A values its inventories at cost or NRV, whichever is less. Entity A has 10 pieces of item A in its stock at the year end. Each item costs Rs. 500. All these items are sold subsequently but before the date of approval of financial statements for the reporting period at Rs. 450 per piece. The sale of inventories after the reporting period normally provides evidence about their net realisable value at the end of the reporting period.

3. SPECIAL ITEMS:

| 1. Equity Dividend Declared | 2. Going Concern | 3. Long Term Loan Arrangements |
|--|---|--|
| <p>Dividend is declared after the balance sheet i.e. generally in AGM</p> <p>Hence there is no obligation on balance sheet date.</p> <p>Hence it is always treated as non-adjusting event.</p> | <p>If after the Balance Sheet date, entity's going concern assumption is no longer appropriate due to happening of an event, then it should adjust Assets and Liabilities of financial statement. (i.e. it is treated as adjusting event)</p> <p>Entity should not prepare its financial statements as per Going Concern Basis.</p> | <p>When 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.</p> <p>If the lender agreed after balance sheet date and before approval of financial statements, not to demand the payment then it is treated as Adjusting Event. (Continue to treat it is Long Term Loan)</p> |

4. Distribution of Non-Cash Assets to Owners

Sometimes an entity distributes non-cash assets as dividends to its equity shareholders, acting in their capacity as owners. In those situations, an entity may also give equity shareholders a choice of receiving either non-cash assets or a cash alternative.

Recognition of Dividend Payable:

The liability to pay a dividend shall be recognised when the dividend is appropriately authorized and is no longer at the discretion of the entity.

Measurement of Dividend Payable:

An entity shall measure a liability to distribute non-cash assets as a dividend to its owners at the **fair value of the assets to be distributed.**

Accounting for any difference:

When an entity settles the dividend payable, it shall recognise the difference, if any, between (a) the carrying amount of the assets distributed and (b) the carrying amount of the dividend payable - in profit or loss.



Student Notes:-

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IND AS 24 – RELATED PARTY DISCLOSURES

Why Ind AS 24?

It is quite probable that a related party relationship **may have an effect on the profit or loss and financial position of an entity**. Therefore, the users of the financial statements of any entity should have the knowledge of:

- Related party relationships of an entity.
- Entity's transactions, outstanding balances, commitments etc. with such related parties.

1. DEFINITIONS

The following definitions are relevant for understanding the Standard:

1. A **related party** can be
 - a person or
 - entity that is related to the reporting entity.
2. **Close members of the family of a person** includes:
 - (a) children, spouse/domestic partner, brother, sister, father and mother.
 - (b) children of that person's spouse or domestic partner; and
 - (c) dependents of that person or his spouse or domestic partner.
3. **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.

Note:

The definition **includes executive as well as non-executive directors** who have responsibility for the management and direction of a significant part of the business. It is not necessary that these people should have the 'director' designation. The term also includes members of the management committee(s), if those committee(s) has the authority for planning, directing and controlling the entity's activities.

Types of Related Party Relationships:

Type 1: Reporting Entity and a Person

Type 2: Reporting Entity and Another Entity

2. TYPE 1 – RELATIONSHIP WITH A PERSON

A **person** or a **close member of that person's family** is related to a reporting entity if that person:

- (a) Has control or joint control over the reporting entity.
- (b) Has significant influence over the reporting entity; or
- (c) Is a member of the key management personnel (KMP) of
 - the reporting entity or
 - a parent of the reporting entity.

Examples 1:

1. Mr. A holds 51% of the equity share capital of A Limited. A Limited has no other form of share capital. Since Mr. A control A Limited, he is a related party.
2. Mrs. A is wife of Mr. A. Mr. A hold 51% of equity shares of A Limited. A Limited has no other form of share capital. Mr. A controls A Limited. Since Mr. A is a related party, Mrs. A is also a related party of A Limited.
3. Mr. D is a director of A Limited. Being a member of key management personnel of A Limited, he is related to A Limited.
4. Mr. D is a director of H Limited. S Limited is a subsidiary of H Limited. Mr. D is related to S Limited.

3. TYPE 2 –RELATIONSHIP WITH ANOTHER ENTITY

Following are the related party relationships:

(a) Parent Company and all subsidiary companies of that Parent are related to each other.

Note: Fellow subsidiary companies are also related to each other.

Example 2:

SA Limited and SB Limited are subsidiaries of H Limited. SA Limited, SB Limited and H Limited are related to each other.

(b) Associate or JV of Parent company or any of its subsidiary companies are related to the parent and all subsidiary companies.

Note:

- i. Subsidiary companies of the above Associate or JV are also related to Parent and all its subsidiaries.
- ii. But Associate/JV of above Associate or JV is not Related Party of the Parent and all its subsidiaries.

Example 3:

AS Limited is an associate of S Limited. S Limited is a subsidiary of H Limited. SH Limited is another subsidiary of H Limited. AS Limited and SH Limited are related parties.

Example 4:

Parent Ltd. has a joint venture in J Ltd. with co-venturer X Ltd. and Parent Ltd. has 35% investment (significant influence) in A Ltd.

Here, Parent Ltd. and J Ltd. are related to each other.

Parent Ltd. and A Ltd. are related to each other.

But Parent Ltd. and X Ltd. (Co-Venturers) are not related to each other.

Example 5:

X Ltd. has Subsidiaries Y Ltd., Z Ltd., A Ltd. & B Ltd.

Also, B Ltd. has an Associate co. C Ltd. and A Ltd. has an associate co. D Ltd.

Here, Group consist of X, Y, Z, A & B only. Entire group is related party of each other.

C Ltd. is related party of all members of group i.e. X, Y, Z, A & B.

D Ltd. is related party of all members of group i.e. X, Y, Z, A & B.

But C Ltd. and D Ltd. are co-associate and are not related party to each other.

Example 6:

R Limited has an associate B Limited. B Limited has a subsidiary S Limited, a joint venture J Limited and an associate A Limited. R Limited is the reporting entity. It identifies B Limited and S Limited as its related parties. J Limited and A Limited are not related parties of R Limited.

(c) Two JV companies of the same Venturer Entity are related to each other.**Example 7:**

H Limited has entered into 2 joint ventures, JHA Limited (joint venture with A Limited) and JHB Limited (joint venture with B Limited). JHA Limited and JHB Limited are related parties.

But H Ltd. and A Ltd. or H Ltd. and B Ltd. are co-ventures and are not related to each other.

(d) Associate of Parent Company and JV of same Parent Company are related to each other.

(**Note:** if Parent company has two associate companies then they are not related to each other)

Example 8:

JH Limited is a joint venture of H Limited. AH limited is an associate of H Limited. JH Limited and AH Limited are related parties.

(e) If a Person (including close family member of that person) or an Entity is having Control/JC over one entity and Control/JC or Significant influence or is a KMP of another entity then both entities are related to each other.**Example 9:**

Mr. A controls A Limited (the reporting entity). He also controls B Limited. A Limited and B Limited are related to each other.

Example 10:

Mr. A controls A Limited (the reporting entity). He is a non-executive director of B Limited. A Limited and B Limited are related parties.

- (f) If an entity is a Post Employment benefit plan for the benefit of employees of reporting entity or any related parties of reporting entity.

4. NO RELATED PARTY RELASHIOSHIPS

- (a) Co-venturers of the same Joint Venture are not related to each other.
- (b) A Person (or his close family member) is a common KMP in both Entities. Both entities are not related to each other.
- (c) A Person (or his close family member) is KMP in one entity and has significant influence in another entity. Both entities are not related to each other.
- (d) Major Customers, Finance Providers, Trade unions, Govt. Departments or agencies, Major Supplier, Franchisor, distributor, Agent etc only because of their business dealings with entity.

Example 11:

Mr. A is a director in X Limited. He is also a director in Y Limited. He has no other interest in either of these companies. There are no transactions between these two entities. X Limited and Y Limited are not related parties.

Example 12:

Mr. A is a director in X Limited. He is also a director in Y Limited. He has no other interest in either of these companies. Y Limited purchases the entire production of X Limited. The transactions are always at arm's length. X Limited and Y Limited may be related parties as it is quite possible that Y Limited may be able to exercise control/significant control over X Limited. As per this Standard substance is more important than mere legal form.

Example 13:

JV Limited is an equal joint venture of J Limited and V Limited. J Limited and V Limited are not related parties.

Example 14:

A Bank and B Bank have provided finance to XY Limited. By virtue of the loan agreement, they occupy a non-executive observer seat on the Board of Directors of XY Limited. A Bank and B Bank are not related parties of XY Limited.

5. RELATED PARTY DISCLOSURES

The disclosure requirements can be broadly classified into two categories.

- (a) **Category 1:** Relationship between Parent & Subsidiary, following disclosures are required **even when there are not transactions between them** during the year:
- 1) Name of Parent or Subsidiary companies.
 - 2) Name of Ultimate Parent Company (if immediate parent is also a subsidiary)
- (b) **Category 2:** Any other Relationship between Entity and a Person or Another entity requires disclosures of relationships and items **only when there are related party transactions** during the year:
- 1) Nature of Related Party Relationship
 - 2) Nature and Amount of Transaction during relationship period
 - 3) Outstanding Balance due from or due to as on balance sheet date
 - 4) Expenses recognised in respect of bad-debts due from related parties
 - 5) Provisions created on outstanding balances from related parties

6. OTHER IMPORTANT POINTS

- 1) A related party transaction can be **transfer of resources, services or obligations** between reporting entity and related entities, such as:
 - purchases or sales of goods (finished or unfinished);
 - purchases or sales of property and other assets;
 - rendering or receiving of services;
 - leases;
 - transfers of research and development;
 - transfers under licence agreements;
 - transfers under finance arrangements (including loans and equity contributions in cash or in kind);
 - provision of guarantees or collateral;
- 2) A reporting entity is also **exempt from the disclosure** requirements in relation to (i) related party transactions (ii) outstanding balances and (iii) commitments with:
 - (a) **a government** that has control, joint control or significant influence over the reporting entity; and
 - (b) another entity that is a related party because the same government has control, joint - control or significant influence over both the reporting entity and the other entity.
 However, it shall disclose:
 - the name of the government.
 - the nature of the government's relationship with the entity



Student Notes:-

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IND AS 34 – INTERIM FINANCIAL REPORTING

Quote:-

Always Remember that your present situation is not your final destination,
the Best is yet to come

PURPOSE OF INTERIM FINANCIAL REPORTING

To update the Shareholders and other stakeholders along with timely information.

1. INTERIM PERIOD MEANS:

Interim period is a financial reporting period **shorter than a full financial year**.

2. INTERIM FINANCIAL REPORT MEANS:

1. Interim financial report means a financial report for less than 1 financial year which contains either a **complete set** of financial statements (as per Ind AS 1) or a **set of condensed financial statements**.
2. **Annual Financial Reporting** means preparation of financial statements for annual period i.e. 1 year as per Ind AS 1.

Note: During the first year of operations of an enterprise its annual financial reporting period may be shorter than a financial year. In such case that shorter period is not considered as an interim period.

3. CONTENTS OF AN INTERIM FINANCIAL REPORT – CONDENSED SET:

An Interim Financial Report shall include the following:

- A condensed balance-sheet
 - A condensed statement of profit and loss
 - A condensed statement of changes in equity
 - A condensed statement of cash flows
 - Notes, comprising significant accounting policies and other explanatory information
- ✓ An entity may be required to or may elect to provide less information at interim dates as compared with its annual financial statements.

- ✓ The interim financial report focuses on new activities, events, and circumstances and does not duplicate information previously reported.
- ✓ **Choice with Entity:** Entity has the option to select either to prepare the Complete set of interim financial reporting or to prepare a set of condensed financial report.

4. PERIODS FOR WHICH INTERIM FINANCIAL STATEMENTS ARE REQUIRED TO BE PRESENTED:

Example: Suppose entity is preparing Interim Financial Report for the period 1st July 20X2 to 30th September 20X2 i.e. 3 Months, then following should be reported:

| | Current Year | Previous Year |
|---|---|--|
| Balance Sheet | As at the End of Current Interim Period i.e. 30 th Sep 20X2 | Comparative BS as at the end of Previous financial year 31 st March, 20X1 |
| Statement of Profit and Loss | <u>Current Interim Period</u> 01/07/X2 - 30/09/X2 <u>Year to Date (CY)</u> 01/04/X2 - 30/09/X2 | <u>Previous Interim Period</u> 01/07/X1 - 30/09/X1 <u>Year to Date (PY)</u> 01/04/X1 - 30/09/X1 |
| Statement of Changes in Equity (SOCIE) | Year to Date Only 01/04/X2 - 30/09/X2 | Year to Date Only 01/04/X1 - 30/09/X1 |
| Statement of Cash Flows | Year to Date Only 01/04/X2 - 30/09/X2 | Year to Date Only 01/04/X1 - 30/09/X1 |

5. RECOGNITION AND MEASUREMENT:

| Sr. No. | Criteria | Recognition and Measurement |
|---------|--|---|
| 1 | Same accounting policies as annual | An entity shall apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. |
| 2 | Recognition of Incomes and Expenses | Incomes and Expenses shall be fully recognised in the same interim period in which they are earned or incurred. |

| | | |
|---|---|---|
| | (Refer Q5 of Question Bank) | <p>Entity should not defer the expenses to next period or anticipate the expenses early from next period on the assumption of higher or lower sales in those periods.</p> <p>Note: Bonus to Employees can be deferred or anticipated.</p> <p><u>Example of such items are:</u> Bad-debts, Marketing and promotion, depreciation, employee benefit expenses, interest cost, general and administration overheads etc.</p> <p>Revenues that are received seasonally, cyclically, or occasionally within a financial year shall not be anticipated or deferred.</p> <p>Examples include dividend revenue, royalties, and government grants.</p> |
| 3 | <p>Fixed Overheads allocation to Production</p> <p>(Refer Q4 of Question Bank)</p> | <p>Step 1: Calculate Fixed Overhead rate per unit:</p> $\frac{\text{Total Fixed Overheads}}{\text{Higher of Normal or Actual Capacity}}$ <p>Step 2: Allocation of Fixed Overheads Actual Production Year to Date x Fixed OH rate (Step 1) (-) Absorbed till last interim period</p> <p>Note: reversal from earlier interim period P&L may also be required in case of Under Recovery.</p> <p>Step 3: Remaining Fixed Overheads Total Fixed Overheads Less Absorbed overheads are charged to Profit and loss.</p> |
| 4 | Tax Expense for Interim Period | <p>Profit/loss of each interim period may contain 2 parts:</p> <ul style="list-style-type: none"> (a) Normal Business Profit and; (b) Special Income (e.g. capital gains) taxable at special rate <p>Tax Expense for Interim Period will be sum of:</p> <ul style="list-style-type: none"> (a) Normal Profit/loss X WATR (b) Special Income X Special Rate <p>Weighted Average Tax Rate (WATR):</p> $\frac{\text{Estimated Annual Tax Amount} \times 100}{\text{Estimated Annual Income}}$ |

| | | |
|---|---|--|
| | | Note: Estimated Annual Tax will be calculated after w/off carried forward losses if given in the question. |
| 5 | Reversal of Impairment Loss | Except for <i>Goodwill</i> , Impairment loss recognised in earlier interim period can be reversed due to change in conditions. |
| 6 | Employer's Contribution to Govt. sponsored funds | Recognise Expenses based on Avg. Effective Contribution Rate given in the Question (Refer Q11 (ii) of Question Bank) |

6. SIGNIFICANT EVENTS AND TRANSACTIONS

The following is a list of events and transactions for which disclosures would be required if they are significant: the list is not exhaustive.

1. The *write-down of inventories to Net Realisable value* and the reversal of such write down;
2. Recognition of a *loss from the impairment* of financial assets, property, plant and equipment, intangible assets, or other assets, and the reversal of such an impairment loss
3. *Acquisitions and disposals of items of property, plant and equipment.*
4. *Litigation settlements.*
5. Corrections of *prior period errors.*
6. Any *loan default or breach of a loan agreement* that has not been rectified on or before the end of the reporting period.
7. *Related party transactions.*
8. Transfers between *levels of the fair value hierarchy* used in measuring the fair value of financial instruments.
9. *Changes in the classification of financial assets* as a result of a change in the purpose or use of those assets; and
10. Changes in *contingent liabilities or contingent assets.*

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IND AS 37 – PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

“Failure is your best asset, complacency is your worst liability,
and talent is your greatest capital.”

1. NON-APPLICABILITY OF INDAS 37

Ind AS 37 doesn't apply to:

- (a) **Executory contracts**, except where the contract is **onerous**; and
- (b) financial instruments (including guarantees) that are within the scope of Ind AS 32 & 109
- (c) Deferred Tax Liabilities (**Ind AS 12, Income Taxes**);
- (d) Lease Liabilities (**Ind AS 116, Leases**), except for **onerous contracts**;
- (e) Employee benefit liabilities (**Ind AS 19, Employee Benefits**); and
- (f) Liabilities relating to Insurance contracts (**Ind AS 117, Insurance Contracts**).
- (g) **Contingent consideration of an acquirer** in a business combination (**Ind AS 103, Business Combinations**)

2. WHAT IS LIABILITY

A Liability is a:

- **Present Obligation** of the Entity
- Arising from **past events**
- Settlement of which is possible only by **outflow of resources** (resources means any asset)

Past Events can create two types of Obligations:

- **Legal obligation** which arises from a contract or law
- **Constructive Obligation** which arises from Past Practices or Commitments. The occurrence of event creates **valid expectations in other parties** that “Entity will discharge its obligations”.
Valid expectations are created when an **entity has committed or communicated to do something**.

Examples of Past Events:

1. In respect of warranty provision, it would be the original sale.
2. In respect of contamination of land, it would be the original contamination.
3. In respect of Provision for dismantling or cleaning the oil rig, it would be when the oil rig is first built.

3. WHAT IS A PROVISION?

Provision is a:

- liability
- of **uncertain** timing or amount
- whose outflow can be **estimated** reliably

Note: *If there is no past event, then there is no liability, and no provision should be recognized.*

| <u>Formulae for Liability</u> | <u>Formulae for Provision</u> |
|---|---|
| Past Event + Present Obligation + Outflow + Certainty of settlement | Past Event + Present Obligation + Outflow probability more than 50% + Uncertain Amt. or Timing + Estimation |

Some Examples on Liabilities and Provisions:

| Nature of obligation | Recognition as provision as per Ind AS 37 (Yes/No) | Reasons |
|---|---|--|
| Amount payable for utilities like electricity, gas, etc. | No | Amount payable for utilities represents an accrual of liability to pay for services that have been received. The amount and timing of payment can be determined with a reasonable certainty. It is a liability. |
| Goods or services received, but not invoiced | No | It is a liability. In such a case, amount and timing of payment would be driven by the terms agreed with the supplier. |
| Financial guarantee given by the parent to lenders for loan taken by its subsidiary | No | Financial guarantees are within the scope of Ind AS 109 Financial Instruments |
| Warranty obligations | Yes | Warranty obligation represents the additional cost that the seller may have to incur to rectify product defects. This is in the nature of provision as there is an uncertainty associated with the amount and timing of the liability. |
| Damages claimed by customer for Rs. 20 Lacs | Yes | If Entity is disputing the amount of claim then there is uncertainty of amount payable. It is a Provision. However, when court has passed the judgement for Rs. 15 Lacs, it will become the liability. |

4. HOW TO MEASURE A PROVISION?

The amount of the provision should be measured at the **best estimate** of the expenditure required to satisfy the obligation at the end of the reporting period.

Methods to Measure the Provision

1. **Expected value method:** this method is used when there are **more than 2 possible outcomes** with probability of each outcome is given. In such a case we need to weight each outcome by its probability. Amount of provision will be equal to the "**Weighted Average Amount**"
2. **The most likely outcome:** This method is suitable in the case there are two possible outcomes. The outcome with highest probability is taken as the amount of Provision.

Discounting (Present Value)

- When the amount of provision is required to be **settled beyond 1 year** then provision should be measured at **Present Value** of future outflow.
- In such a case, **interest cost** shall be recognised to unwind the discount over the period in Profit and Loss account.
- Discount rate should be taken **pre-tax always**.
- If there is risk of actual outflow more than present value, the amount of present value shall be **increased by % of risk factor**.

Examples of Best Estimate:

An entity faces a single legal claim, with a 40 percent likelihood of success with no cost and a 60 percent likelihood of failure with a cost of ₹1 million. Expected value is not valid in this case because the outcome will never be a cost of ₹600,000 (60 percent × ₹1 million); the outcome will either be nil or ₹1 million. Ind AS 37 indicates that the provision may be estimated at the individual most likely outcome. In this example, it is more likely that a cost of ₹1 million will result and, therefore, a provision for ₹1 million should be recognised.

(Author Note - When there are only 2 outcomes use MOST LIKELY OUTCOME)

Other Important Points for Provision

- 1) Provision should not be made for "**Future operating losses**" since there is no past obligating event.
- 2) Provision should be recognised as soon as the obligating event takes place such as:
 - Sale of Product with warranty, provision should be recognised on the date of sale
 - PPE Installed with decommissioning cost, provision should be recognised as on PPE recognition date
- 3) Legal or Constructive obligation **should be present as on Balance Sheet** to create a Liability or Provision.
- 4) **Onerous Contracts:** Provision should be created **at lower of:**
 - a) Net Cost of Completing the Contract or

b) Penalty Cost of Cancellation of Contract

Note: Onerous contract means a contract in which the **unavoidable cost** (labor cost, material cost, variable production overheads) of meeting the obligation **exceeds the expected benefits** to be obtained. (e.g. Binding sale agreement or non-cancellable contract)

5) In case of **Executory contracts, no provision is required.**

Executory contracts are contracts under which

- Neither party has performed any of its obligations or
- Both parties have partially fulfilled their obligations to an equal extent.

6) When probability is given in the question then check **if there is more than 50% chance** of outflow then only provision is recognised.

7) If there is **difficulty in estimating the provision** amount due to unavailability of data or past experience, it is **not justified to ignore the provision** or not create the provision. **Provision should be recognised based on industry data.**

8) **Reimbursements:**

- If any expenditure is expected to be reimbursed by the other party and it is virtually certain to be received (more than 90% chance) then such **reimbursement shall be recognised as a separate asset in the Balance Sheet.**
- **In the profit and loss account, provision can be presented net of reimbursement income.**
- Amount of Reimbursement can never exceed the provision amount.

9) Provision should be **reviewed at each balance sheet date** and adjusted as per the current best estimate. If it is no longer required, then reverse the provision.

10) If the **entity can avoid any future expenditure by its future actions**, then **NO provision** is recognised for such expenditure. Example - future operating costs such as inspection of ships in the next 5 years, company can sale the ship before 5 years then no provision of inspection is required.

11) **Restructuring:**

a) Restructuring is a plan of management to **change the scope of business or the manner of conducting a business.**

Example: discontinuing a line of business or closure of one or two segments or operations

b) Provision for restructuring cost is required when:

- There is a **detailed formal plan** for restructuring with relevant information in it (about business, location, employees, time schedule and expenditures)
- A **valid expectation** related to restructuring has been raised in the affected parties.

c) Restructuring provision should include only **the direct expenditures** such as staff termination cost, compensation to customers, lease termination penalty etc.

d) Following costs are not considered for restructuring provision:

- Training cost of employees
- Cost of relocating asset from one location to another
- Impairment cost

Example on Restructuring Cost:**Closure of a division - communication/ implementation before end of the reporting period**

On 12th March, 20X1 (reporting date), the board of an entity decided to close down a division making a particular product. On 20th March, 20X1 a detailed plan for closing down the division was agreed by the board; letters were sent to customers warning them to seek an alternative source of supply and redundancy notices were sent to the staff of the division. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event - The obligating event is the communication of the decision to the customers and employees, which gives rise to a constructive obligation from that date, because it creates a valid expectation that the division will be closed.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised at 31st March, 20X1 for the best estimate of the costs of closing the division.

IMPORTANT EXAMPLES ON PROVISION**1. Example on Legal requirement to fit smoke filters**

Under new legislation, an entity is required to fit smoke filters to its factories by 30th September, 20X1. The entity has not fitted the smoke filters. It is assumed that a reliable estimate can be made of any outflows expected.

(a) At 31st March, 20X1, the end of the reporting period

Present obligation as a result of a past obligating event - There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.

Conclusion - No provision is recognised for the cost of fitting the smoke filters.

(b) At 31st March, 20X2, the end of the reporting period

Present obligation as a result of a past obligating event - There is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

An outflow of resources embodying economic benefits in settlement - Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

Conclusion - No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed.

2. Example Contaminated land and constructive obligation

An entity in the oil industry (having 31st March year-end) causes contamination and operates in a

country where there is no environmental legislation. However, the entity has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. The entity has a record of honoring this published policy. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event- The obligating event is the contamination of the land, which gives rise to a constructive obligation because the conduct of the entity has created a valid expectation on the part of those affected by it that the entity will clean up contamination.

An outflow of resources embodying economic benefits in settlement- Probable.

Conclusion- A provision is recognised for the best estimate of the costs of clean-up.

3. Example Offshore oilfield

An entity operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. 90% of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and 10% arise through the extraction of oil. At the end of the reporting period, the rig has been constructed but no oil has been extracted. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event - The construction of the oil rig creates a legal obligation under the terms of the license to remove the rig and restore the seabed and is thus an obligating event. At the end of the reporting period, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it. These costs are included as part of the cost of the oil rig. The 10% of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted

4. Example on Warranties

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (i.e., more likely than not) that there will be some claims under the warranties. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event - The obligating event is the sale of the product with a warranty, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement - Probable for the warranties as a whole.

Conclusion - A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the end of the reporting period

5. WHAT ARE CONTINGENCIES?

In Addition to Liabilities and Provisions, Ind AS 37 deals with Contingent Liabilities and Contingent Assets.

Contingent Liabilities:

A **contingent liability** is either:

- A **possible obligation** (not present) from past event that will be confirmed by occurrence or non-occurrence of uncertain future event; or
- A present obligation from past event, but either:
 - The outflow of resources to satisfy this obligation is **not probable** (less than 50%), or
 - The amount cannot be reliably measured.

Treatment of Contingent Liability:

- Contingent liability shall not be recognised.
- It should be disclosed in Notes to Financial Statements.
- If the probability of outflow is less than 5% i.e. remote then disclosure is even not required.

Contingent Assets

A **contingent asset** is a **possible asset** arising from past events that will be confirmed by occurrence or non-occurrence of uncertain future events not fully under the entity's control.

Situations

| Likelihood of outcome | Contingent liability | Contingent asset |
|---|-----------------------------------|-------------------------------|
| Virtually certain (greater than 95% probability) | Recognise the Provision | Recognise the Asset |
| Probable (50% - 95% of probability) | Recognise the Provision | Disclose the Contingent Asset |
| Possible but not probable (5% - 50% of probability) | Disclose the Contingent Liability | Disclosure is not required |
| Remote (less than 5% probability) | Disclosure is not required | Disclosure is not required |

6. LEVIES (APPENDIX C OF IND AS 37)

- **Levies under Ind AS 37** refer to **mandatory payments** made by entities to **governments** or authorities as per laws or regulations.
- Entities recognize a liability for a levy when the activity **triggering the payment occurs**, such as exceeding pollution limits.
- The liability is **measured based on the best estimate** of the payment required and disclosed in financial statements, including its nature and any changes.

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IND AS 108 – OPERATING SEGMENTS

Quote:

“Make Improvements, Not Excuses. Seek Respect, Not Attention”

1. SEGMENT REPORTS

This standard requires entity to prepare a Segment wise report of entire business so that the stakeholders can understand and evaluate the performance of business on segment wise.

Segment report is not a part of Financial Statements. Also this Ind AS provides following guidelines to prepare a segment report:

1. First of all, identify the operating segments of business
2. Make aggregation of similar operating segments
3. Identify Reportable Segments from operating segments (Quantitative Threshold)
4. Prepare segment reports

SEGMENT REPORT FOR CONSOLIDATION & SEPARATE FINANCIAL STATEMENTS

If a financial report contains both the consolidated financial statements of a parent that is within the scope of Ind AS 108 as well as the parent's separate financial statements, segment information is required **only in the consolidated financial statements.**

STEP 1 - IDENTIFY OPERATING SEGMENTS

An operating segment is a component of an entity that should have following characteristics:

- (a) It is engaged in business activities from which **it may earn revenues and incur expenses;**
- (b) Whose **operating results (Profits/Losses or sometimes revenues) are regularly reviewed by the entity's chief operating decision maker (CODM) to take decisions; and**
- (c) For which **discrete financial information** is available (like Incomes, Expenses, Assets, Liabilities etc)

Note:

1. CODM can be a Managing Director (Single Person) or Group of Person (Board of Directors).
2. Non-executive directors cannot be CODM.
3. An operating segment may engage in business activities for which it has yet to earn revenues, for example, **start-up operations may be operating segments** before earning revenues.
4. If the discontinued operation
 - **Continues to engage in business activities;**

- Whose operating results are reviewed by the CODM; and
- There is discrete information available to support the review

Then, it would meet the definition of an operating segment.

5. Following are **not Operating Segments**:

- a) Corporate Headquarters
- b) Post Employment Benefits Plan

6. Research and Development function of an entity can be an operating segment provided discrete financial information is available.

Example 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.

STEP 2 – AGGREGATION OF SIMILAR OPERATING SEGMENTS

Two or more operating segments may be aggregated into a single operating segment if the segments have **similar economic characteristics (i.e. similar profit margin)**, and the segments are similar in each of the following respects:

- (a) The nature of the products and services.
- (b) The nature of the production processes.
- (c) The type or class of customer for their products and services;
- (d) The methods used to distribute their products or provide their services; and
- (e) If applicable, the nature of the regulatory environment, for example, banking, insurance or public utilities.

STEP 3 – REPORTABLE SEGMENTS

Those operating segments of entity for which separate financial information is required to be disclosed separately along with the financial statements. Operating Segments will be considered as reportable when any one of the following criteria is fulfilled:

(a) If **Revenue (Sales)** of a segment is **equal to or more than 10%** of the combined revenue (sales) of all segments.

Revenue means **both External Revenue** from Outside Customers and **Internal Revenue** from inter segment sales.

(b) If **profit or loss** of that segment is **equal to or more than 10%** of the combined result of all segments.

Combined Result means **higher of:**

- (i) Combined Profit of all segments in Profits
- (ii) Combined Loss of all segments in Losses

(c) If **Assets** of that segment **are equal to or more than 10%** of the combined Assets of all Segments.

Minimum 75% criteria:

If the total **external revenue** reported by operating segments constitutes less than 75% of the entity's revenue, additional operating segments should be identified as reportable segments (even if they do not meet the criteria) until **at least 75% of the entity's revenue** is included in reportable segments.

(i.e. External revenue of reportable segments **must be \geq 75% of the total external revenue** of the entity)

Choice of Management:

Entity can report **any additional segment** as reportable segment even though it does not meet the above criteria.

Non-reportable segments:

All remaining segments which are not reportable separately should be combined and disclosed as **"Other Segments"** in Segment Report.

STEP 4 – PREPARE A SEGMENT REPORT (DISCLOSURES)

| Particulars | Segment 1 (Reportable) | Segment 2 (Reportable) | Other Segments | Total |
|---|---------------------------|---------------------------|-------------------|-------------|
| 1. <u>Segment Profit or Loss:</u> | | | | |
| Segment Revenue (Gross) | | | | |
| Domestic: | XXX | XXX | XXX | XXX |
| Exports: | XXX | XXX | XXX | XXX |
| Inter Segment Sales: | XXX | XXX | XXX | XXX |
| (-) GST | (XX) | (XX) | (XX) | (XX) |
| Segment Revenue (Net) | XXXX | XXXX | XXXX | XXXX |
| (+) Other Operating Incomes | XXX | XXX | XXX | XXX |
| Total Revenue | XXXX | XXXX | XXXX | XXXX |
| (-) Segment Expenses | XXX | XXX | XXX | XXX |
| Segment Profit/(loss) | XXX | XXX | XXX | XXX |
| (+) Unallocated Incomes less Expenses | | | | XXX |
| Net Profit before Interest & Tax | | | | XXX |
| (-) Interest & Other Finance Cost | | | | XXX |
| Net Profit before Tax | | | | XXX |
| (-) Tax Expenses (Current +/- Deferred) | | | | (XX) |

| | | | | |
|--|------|------|------|------|
| Profit After Tax (Entire) | | | | XXX |
| 2. Segment Assets & Liabilities | | | | |
| (i) Assets: | | | | |
| Segment Assets | XXXX | XXXX | XXXX | XXXX |
| Unallocated Assets | | | | XXXX |
| Total Assets (Entire) | | | | XXXX |
| (ii) Equity and Liabilities: | | | | |
| Segment Liabilities | XXXX | XXXX | XXXX | XXXX |
| Unallocated Liabilities | | | | XXX |
| Share Capital | | | | XXXX |
| Reserves & Surplus | | | | XXXX |
| Total Equity and Liabilities (Entire) | | | | XXXX |
| 3. Other Information: | | | | |
| Capital Expenditure During the Year | XXX | XXX | XXX | XXX |
| Depreciation & Amortisation | XXX | XXX | XXX | XXX |

| Geographical Information: | Domestic | Foreign Country 1 | Foreign Country 2 | Total |
|---|-----------------|--------------------------|--------------------------|--------------|
| Total Revenue | XXX | XXX | XXX | XXX |
| Total Assets | XXX | XXX | XXX | XXX |
| Total Capital Expenditure During the Year | XXX | XXX | XXX | XXX |

MEASUREMENT: How the items to be reported are measured?

- 1) Same measurement basis as used by CODM.
- 2) Reconciliation with financial statements will be required.

Example 2:

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.

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IND AS 113 – FAIR VALUE MEASUREMENT

Quote:

Hard Work in Silence. Let Success make the Noise.

Many IND AS requires the entities to measure the fair value of some items. Such as financial instruments, biological assets, assets held for sale, PPE, Business Combination etc.

1. WHAT IS FAIR VALUE?

- 1) Fair value is the price
 - that would be received to sell an asset or paid to transfer a liability
 - in an orderly transaction (under fair conditions and without any pressure)
 - between market participants (independent buyer and seller)
- 2) Fair Value is also known as Exit Price.
- 3) While determining fair value, entity specific restrictions should not be considered but Asset Specific restrictions should be considered.

Example: Entity Specific restrictions

An entity has land which has a restriction to develop into a commercial house because of restricted business objective in which currently the entity operates. The entity wants to sell the land and there would not be any restriction for a buyer of the land to develop a commercial house, since this restriction is entity specific. Hence, it will not be considered while calculating the fair value of the land.

Example: Asset specific restrictions

A car has been bought for private use and there is a restriction on "not to use the car for any commercial purposes". Commercial vehicles have more fair value than private vehicles. Since the restriction to use the vehicle is asset specific and market participant will also consider the asset specific restrictions while calculating fair values for such asset, hence this condition will be considered while evaluating fair value of the car.

- 4) For measurement of Fair Value, price reference should be taken either from "Principal Market" or "Most Advantageous Market"

2. PRINCIPAL VS. MOST ADVANTAGEOUS MARKET

A fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place either:

- in the "Principal Market" (1st Preference); or
- in the "Most Advantageous Market" (2nd Preference)

| Principal market | Most Advantageous market | | | | | | | | | | | | |
|---|--|-----------------------------|-----|-------------------------|------|----------------------|------|---------------------------------|------------|-----------------------------|-----|-------------------------|------|
| Principal market is the market where Asset or Liability is transacted with highest volume. | The Most Advantageous market is the market where Net Amount received on sale of Asset is Maximum (or) Net amount paid on transfer of liability is Minimum, after considering transaction costs and transport costs. | | | | | | | | | | | | |
| <p>Example:</p> <p>The share of a company which is listed at BSE and NSE has different closing prices at the year end. The price at BSE has the highest volume and activity whereas at NSE it is less in terms of volume transacted in the period. Since BSE has got the highest volume and significant level of activity comparing to other market although the closing price is higher at NSE. BSE is considered as Principal Market and NSE is considered as Most Advantageous Market. The closing price at BSE would be taken since principal market is available.</p> | | | | | | | | | | | | | |
| <u>How to measure Fair Value?</u> | <u>How to measure Fair Value?</u> | | | | | | | | | | | | |
| Price of Asset or Liability XXX (-) Transportation Cost (XX) | <p style="color: #4F81BD;">Step 1: Identify Most Advantageous Market from different markets with following calculations of different markets:</p> <table style="width: 100%; border-collapse: collapse;"> <tr><td style="width: 70%;">Price of Asset or Liability</td><td style="text-align: right;">XXX</td></tr> <tr><td style="width: 70%;">(-) Transportation Cost</td><td style="text-align: right;">(XX)</td></tr> <tr><td style="width: 70%;">(-) Transaction Cost</td><td style="text-align: right;">(XX)</td></tr> <tr><td style="width: 70%;">Net Amount Received/Paid</td><td style="text-align: right;">XXX</td></tr> </table> <p style="color: #4F81BD;">Step 2: Calculate the Fair Value</p> <table style="width: 100%; border-collapse: collapse;"> <tr><td style="width: 70%;">Price of Asset or Liability</td><td style="text-align: right;">XXX</td></tr> <tr><td style="width: 70%;">(-) Transportation Cost</td><td style="text-align: right;">(XX)</td></tr> </table> | Price of Asset or Liability | XXX | (-) Transportation Cost | (XX) | (-) Transaction Cost | (XX) | Net Amount Received/Paid | XXX | Price of Asset or Liability | XXX | (-) Transportation Cost | (XX) |
| Price of Asset or Liability | XXX | | | | | | | | | | | | |
| (-) Transportation Cost | (XX) | | | | | | | | | | | | |
| (-) Transaction Cost | (XX) | | | | | | | | | | | | |
| Net Amount Received/Paid | XXX | | | | | | | | | | | | |
| Price of Asset or Liability | XXX | | | | | | | | | | | | |
| (-) Transportation Cost | (XX) | | | | | | | | | | | | |
| <p>Note:</p> <p>1) Transportation cost means the cost that would be incurred to transport the asset from the current location to the principal or most advantageous market.</p> <p>2) Transaction cost should be considered only while determining the Most Advantageous Market from different markets.</p> | | | | | | | | | | | | | |

(Refer Q9 of Question Bank)

3. FAIR VALUE HIERARCHY

While determining the fair value of any Asset or Liability some inputs are taken as a reference point from Principal Market or Most Advantageous Market.

Examples of Inputs:

- a) Quoted Market Price of Share of any listed company
- b) Market Interest Rates
- c) Property Rates
- d) Expected Future Cash Flows

The Fair Value hierarchy is a framework used to classify the inputs used to measure fair value into three different levels to ensure that fair value measurements are transparent and reliable.

Fair Value hierarchy levels:

- a) **Level 1 Inputs:** These are quoted market prices of Assets and Liabilities. These are most reliable and transparent inputs. Such as Market Price of any Listed company traded in NSE or BSE.
- b) **Level 2 Inputs:** Unlike Level 1 inputs, Level 2 inputs don't involve the exact same asset or liability being actively traded in the market. Instead, they might involve prices for similar assets or inputs derived from market data.

For example:

- (i) if a property owned by a company like Godrej Properties needs to be valued, but that exact property isn't actively traded in the market, we can use prices of similar properties in the same locality as Level 2 inputs.
 - (ii) When valuing bonds issued by a company like HDFC, we may not have the exact quoted price for every bond. However, we can use observable interest rates of similar bonds or debt securities to estimate the bond's fair value.
- c) **Level 3 Inputs:** These are unobservable inputs (non-market inputs). These inputs are typically based on internal assumptions and estimates making them less reliable compared to level 1 & 2 inputs.

Example: Present Value of forecast cash flows

[Refer Q5 (ii) of Question Bank]

4. VALUATION TECHNIQUES

Valuation technique refers to the method used to determine the fair value of an asset or liability. The goal of these techniques is to estimate what a willing buyer would pay to a willing seller in an orderly transaction under current market conditions.

Valuation techniques are broadly categorized into three approaches:

- 1) **Market Approach:** takes inputs from market transactions for identical or comparable Assets/liabilities.
- 2) **Cost Approach:** This technique uses replacement cost of assets. This technique is often used for machines and properties
- 3) **Income Approach:** This technique involves converting future amounts (e.g., cash flows or income) to a present value using a discount rate.

MARKET APPROACH

Market approach uses level 1 and level 2 inputs only. Under this approach following different valuation techniques are covered:

a) **Comparable Companies Method:** based on industry's Enterprise value and EBITDA, the value of a particular company is calculated as under:

| | | |
|----|---|-----|
| A) | EV/EBITDA Multiple of Industry (Given in the question) | XX |
| B) | EBITDA of the Particular Companies | XXX |
| C) | $A \times B = \text{Enterprise Value}$ | XXX |
| D) | (+) Cash & Cash Equivalent and FV of other Assets (-) Value of Debts outstanding | XXX |
| E) | Total Value | XXX |
| F) | (-) Liquidity discount % (or) non-controlling stake discount % | XX |
| G) | Final Equity Value of the Company | XXX |
| H) | Value per Equity Share $\text{Final Equity Value} \div \text{No. of Shares}$ | XX |

(Refer Q2 of Question Bank)

What is Liquidity discount:

Example: If you have a piece of land in a remote area and want to sell it, it might take a long time to find a buyer. Because of this, the price might be reduced, say by 5%, to make it attractive. Similarly, the liquidity discount reduces the share's value due to the challenge of selling it quickly because of private companies share. A liquidity discount (5%) is applied because XYZ Ltd.'s shares aren't easily tradable.

What is non-controlling interest discount:

Example: A non-controlling shareholder (like owning 5% of XYZ Ltd.) has limited influence on important decisions, such as business strategy, dividend payouts, or selling the company. Because of this lack of control, the shares are considered less valuable compared to someone who owns a larger controlling stake. Non-controlling stake discount (5%) is applied because ABC Ltd. holds only a small (non-controlling) stake in XYZ Ltd.

b) **PE Ratio Method:** Take Industry's PE Ratio as base

| | | |
|----|---|-----|
| A) | Company's Earnings (Given in the question) | XXX |
| B) | P/E Ratio of Industry | XX |
| C) | $A \times B = \text{Enterprise Value}$ | XXX |
| D) | (-) Liquidity discount % (or) non-controlling stake discount % | XX |
| E) | Final Equity Value of the Company | XXX |
| F) | Value per Equity Share $\text{Final Equity Value} \div \text{No. of Shares}$ | XX |

(Refer Q8 of Question Bank)

c) Net Assets Value:

| | | |
|----|--|-----|
| A) | Fair Value of All Assets of Company | XXX |
| B) | (-) Fair Value of All Liabilities of Company | XX |
| C) | Final Equity Value of Company | XXX |
| D) | Value per Equity Share Final Equity Value ÷ No. of Shares | XX |

INCOME APPROACH (Level 3 Inputs)

Here the valuation is determined by calculating the present value of expected future cash inflows using appropriate discount rate:

| | | |
|----|---|-----|
| A) | PV of Annual Cash Flows using discount rate | XXX |
| B) | PV of Terminal Cash Flows using discount rate | XXX |
| C) | Total Free Cash Flows Available to the Company | XXX |
| D) | (+) Cash & Cash Equivalent and FV of other Assets (-) Value of Debts outstanding | XXX |
| E) | Final Equity Value of the Company | XXX |
| H) | Value per Equity Share Final Equity Value ÷ No. of Shares | XX |

(Refer Q3 of Question Bank)

Note: Combination of more than 1 valuation technique is also allowed to measure fair value.

(Refer Q4 of Question Bank)

5. OTHER IMPORTANT PROVISIONS

1) Calculation of Fair Value of De-commissioning Liability (Asset Retirement Obligation):

| | |
|--|-----|
| Expected Labor Cost of Decommissioning Liability | XXX |
| Expected Overhead Cost of Decommissioning Liability | XXX |
| Total Cost of Decommissioning Liability | XXX |
| (+) Profit Markup (%) | XXX |
| Total Expected Cash Flows (Real Cash Flows) | XXX |
| (+) Premium % for covering risk of excess cash flows above real cash flows | XX |
| Total Expected Cash Flows with Premium without Inflation | XXX |
| (x) Inflation Factor given in the question covering the life of Asset | XX |
| (=) Total Expected Cash Flows after Inflation Factor | XXX |
| Discount Rate (%) | X% |
| Risk Free Rate + Non-performance Risk Rate | |
| Non-performance risk rate is considered to assess the likelihood that company may fail to meet its decommissioning obligation. | |
| Expected Present Value after discounting of Expected Cash flows | XXX |

(Refer Q7 of Question Bank)

2) Fair Value of Non-financial Assets (i.e. PPE, Intangible Assets, Investment Property etc):

- a) While determining fair value of Non-financial Assets, entity should consider "Highest & Best Use of the Asset"
- b) Highest and best use of a non-financial asset refers to the use that would result in the highest value for the asset.
- c) The highest and best use takes into account the use of the asset that is:
 - physically possible
 - legally permissible
 - financially feasible

d) Example:

A piece of land in a fast-growing city like Bangalore.

Legally Permissible: The land is currently zoned for agricultural use, but the government allows rezoning to commercial or residential use.

Physically Possible: The land is flat and has access to main roads, which makes it physically possible to build high-rise apartments, a mall, or office space.

Financially Feasible: If we build a commercial office space, the demand for office rentals in that area is high, and rental income will generate good returns. However, the costs of building and maintaining an office might be higher than expected rental income.

Maximally Profit: After comparing different options (agriculture, residential, office), it is determined that building a residential complex will give the highest profit because the demand for homes in that area is booming, and the cost of construction is reasonable compared to the potential sale prices.

In this case, the highest and best use of the land might be residential development.

[Refer Q1, Q5(i)]

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IND AS 101 – FIRST TIME ADOPTION OF IND AS

Quote:

If you can't do Great things, do small things in Great ways.

1. INTRODUCTION

- 1) Ind AS 101 prescribes the accounting principles for the first time adoption of Ind AS.
- 2) Conceptually, the accounting under Ind AS should be applied retrospectively at the time of transition to Ind AS
- 3) However, Ind AS 101 grants *limited exemptions* from these requirements in specified areas where the cost of complying with them would be likely to exceed the benefits to users of financial statements.
- 4) Ind AS 101 also prohibits retrospective application of Ind AS in some areas (called exceptions), particularly where retrospective application would require judgments by management about past conditions after the outcome of a particular transaction is already known.

2. DEFINITIONS

- (a) **Date of transition to Ind AS:** The beginning of the earliest period for which an entity presents full comparative information under Ind AS in *first Ind AS financial statements*.
- (b) **First Ind AS financial statements:** 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.
- (c) **First Ind AS reporting period:** The latest reporting period covered by an entity's first Ind AS financial statements.
- (d) **First-time adopter:** An entity that presents its first Ind AS financial statements.
- (e) **Opening Ind AS balance sheet:** An entity's balance sheet at the date of transition to Ind AS.
- (f) **Previous GAAP:** The basis of accounting that a first-time adopter used for its statutory reporting requirements in India immediately before adopting Ind ASs. For instance, companies required to prepare their financial statements in accordance with Section 133 of the Companies Act, 2013, shall consider those financial statements as previous GAAP financial statements.

3. OBJECTIVE

The objective of Ind AS 101 is to ensure that an entity's first Ind AS financial statements, and its interim financial reports for part of the period covered by those financial statements, contain high quality information that:

- is **Transparent** for users and **Comparable** over all periods presented;

- provides a **suitable starting point** for accounting in accordance with Ind ASs; and
- can be **generated at a cost that does not exceed the benefits**

4. HOW AN ENTITY ADOPTS IND AS?

- Ind-AS 101 applies when an entity adopts Ind-AS for the first time by an **explicit and unreserved statement of compliance with Ind-ASs**.
- This means compliance **with ALL Ind-ASs**.
- **Partial Compliance is not enough** to make an entity Ind-AS Compliant.

5. WHEN TO APPLY THIS INDAS 101?

An entity shall apply this standard -

- in its first Ind-AS compliant financial statements, and
- In each interim financial report, if any, presented in accordance with Ind AS 34, *Interim Financial Reporting*, for part of the period covered by its first Ind AS financial statements.

For example 1:

If a company adopts Ind ASs for the financial year 2016-17, the following are the relevant Ind AS adoption date/period:

- The date of transition is 1.4.2015;
- Comparative period to the first Ind AS financial statements period is 2015-16; and
- First Ind AS financial statements period is 2016-17.

An entity would apply Ind ASs consistently. It is required to apply Ind ASs effective for the period ending on 31 March, 2016 the purposes of -

- Preparation and presentation of opening Ind AS Balance Sheet as on 1.4.2015;
- Preparation and presentation of comparative financial statements for the period 2015-16;
- Preparation and presentation of first Ind AS financial statements for the period 2016-17; and
- This standard will not be applied on and from the second financial year of Ind AS adoption i.e. for the financial year 2017-18.

An entity shall not apply different versions of Ind ASs that were effective at earlier dates. It may apply a new IndAS that is not yet mandatory if that Ind AS permits early application.

6. Uniform Accounting Policies

Entity uses the same accounting policies in its opening Ind AS Balance Sheet and through all periods presented in its first Ind AS financial statements. Those accounting policies shall comply with each Ind AS effective at the end of its first Ind AS reporting period, subject to:

- Mandatory exceptions and
- Optional exemptions

7. IND AS 101 – SPECIFIC REQUIREMENTS

It may be noted that the way Ind AS 101 is structured, it first lays down the general principle that all Ind AS, as effective for the first Ind AS reporting period, should be applied retrospectively i.e. at the starting point, which is the opening Ind AS balance sheet, should carry the balances as if Ind AS has always been applied by the company in the past.

Once the general principle has been specified, Ind AS 101 then talks about certain (a) exemptions and (b) exceptions, the former being voluntary and the latter being mandatory, as mentioned above.

- (a) **Recognise** All Assets and Liabilities whose recognition is required by IND AS
- (b) **Not recognize** items as Assets or Liabilities if Ind AS do not permit such recognition
- (c) **Reclassify** items that it recognised under previous GAAP as one type of Asset, Liability or component of equity, but a different type of asset, liability or component of equity under Ind AS and
- (d) Apply Ind AS in **Re-measuring** all Recognised Assets and Liabilities.

| | | | |
|-------------|----------------|------------------|----------------|
| Recognition | De-recognition | Reclassification | Re-Measurement |
|-------------|----------------|------------------|----------------|

RECOGNISE (Examples)

- Defined benefit pension plans (Ind-AS 19)
- Deferred taxation (Ind-AS 12)
- Assets and liabilities under Appendix C Decommissioning Liability commissioning
- Provisions where there is a legal or construction obligation (Ind-AS 37)
- Derivative financial instruments (Ind-AS 39)
- Share-based payments (Ind-AS 2)

DE-RECOGNISE (Examples)

- Internally generated intangible assets (Ind-AS 38)
- Deferred tax assets where recovery is not probable (Ind-AS 12)
- Provision for Dividend (Ind-AS 10)
- Preliminary & Pre-Operative expenses.

RECLASSIFY (Examples)

- Investments accounted for in accordance with Ind-AS 39
- Certain financial instruments previously classified as equity
- Any assets and liabilities that have been offset where the criteria for offsetting in Ind-AS are not met—for example, the offset of an insurance recovery against a provision.
- Noncurrent assets held-for-sale (Ind-AS 5)
- Non-controlling interest (Ind-AS 27)

MEASURE OR REMEAURE (Examples):

- Receivables (Ind-AS 18)
- Inventory (Ind-AS 2)

- Employee benefit obligations (Ind-AS 19)
- Deferred taxation (Ind-AS 12)
- Financial instruments (Ind AS 39)
- Investment Property (Ind AS 40)
- Property Plant & Equipment (Ind-AS 16)

SAME ACCOUNTING POLICIES:

An entity shall prepare and present an opening Ind AS balance sheet at the date of transition to Ind AS. This is the starting point for its accounting in accordance with Ind AS.

8. MANDATORY EXEMPTIONS & OPTIONAL EXCEPTIONS

There are two categories of provisions in Ind AS 101 under which the general principle mentioned above is applied in a modified manner:

1. Mandatory exceptions to the retrospective application of other Ind AS
2. Optional exemptions from retrospective application of other Ind AS

8.1 MANDATORY EXEMPTIONS

(Exceptions to Retrospective Application of Other IndAS)

General Rule - Retrospective Application of all INDAS when apply first time.

1. **Estimates:** An entity's estimates in accordance with Ind AS at the date of transition to Ind AS shall be consistent with estimates made for the same date in accordance with previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error.

In other words, estimates made by the entity in accordance with local GAAP shall not be changed in view of the developments after the transition date.

For example 2: an entity made provision on 31st March,2015, for Rs. 1 lakh. By the time the entity prepares 1st Ind-AS Financial Statements - the said liability was settled for Rs. 80,000.

How much should the provision be measured at when an entity makes in the 1st Ind-As Financial Statement prepared on 1st April,2011?

A.Rs. 80,000 or B. 1,00,000

The Answer is B,

2. **Non-controlling Interests:** A first-time adopter shall apply the following requirements of Ind AS 110 **prospectively from the date of transition** to Ind AS:

- (a) Total comprehensive income is attributed to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance;
- (b) Accounting for changes in the parent's ownership interest in a subsidiary that do not result in a loss of control; and

(c) Accounting for a loss of control over a subsidiary,

However, if a first-time adopter elects to apply Ind AS 103 retrospectively to past business combinations, it shall also apply Ind AS 110 from that date.

3. Government Loans: A first-time adopter shall classify all government loans received as a financial liability or an equity instrument in accordance with Ind AS 32, Financial Instruments: Presentation.

A first-time adopter shall apply the requirements in Ind AS 109, Financial Instruments, and Ind AS 20, Accounting for Government Grants and Disclosure of Government Assistance, prospectively to government loans existing at the date of transition to Ind AS and shall not recognise the corresponding benefit of the government loan at a below-market rate of interest as a government grant.

Example 3

Government of India provides loans to MSMEs at a below-market rate of interest to fund the set-up of a new manufacturing facility. Company A's date of transition to Ind AS is 1 April 20X5. In 20X2, Company A had received a loan of ` 1 crore at a below-market rate of interest from the government. Under Indian GAAP, Company A accounted for the loan as equity and the carrying amount was ` 1 crore at the date of transition. The amount repayable at 31 March 20X9 will be ` 1.25 crore. The loan meets the definition of a financial liability in accordance with Ind AS 32. Company A 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 1 April 20X5 as below: $EIR = \text{Amount} / \text{Principal}(1/t)$ i.e. $1.25/1(1/4)$ i.e. 5.74%. approx. At this rate, ` 1 crore will accrete to ` 1.25 crore as at 31 March 20X9.

| Year Ended | Opening Amortized Cost (Rs.) | Interest Expense for the Year (Rs.) @ 5.74% p.a. approx. | Closing amortized cost (Rs.) |
|---------------|------------------------------|--|------------------------------|
| 31 March 20X6 | 1,00,00,000 | 5,73,713 | 1,05,73,713 |
| 31 March 20X7 | 1,05,73,713 | 6,06,627 | 1,11,80,340 |
| 31 March 20X8 | 1,11,80,340 | 6,41,430z | 1,18,21,770 |
| 31 March 20X9 | 1,18,21,770 | 6,78,230 | 1,25,00,000 |

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. That means interest expense as per ERI shall be recognised prospectively from the transition date.

4. Hedge accounting

Transactions entered into before the date of transition to Ind ASs shall not be retrospectively designated as hedges.

At the date of transition to Ind AS an entity shall:

- (a) measure all derivatives at **fair value**; and
- (b) **eliminate all deferred losses and gains** arising on derivatives that were reported in accordance with previous GAAP as if they were assets or liabilities.

An entity shall not reflect in its opening Ind AS Balance Sheet a hedging relationship of a type that does not qualify for hedge accounting in accordance with Ind AS 109

5. Classification & measurement of financial assets and financial liabilities

Ind AS 109 contains principles for classification of a financial asset as at (a) amortised cost or (b) fair value through other comprehensive income or (c) fair value through profit or loss. Such classification depends on assessment of features of the financial asset on the date of its initial recognition.

Ind AS 101 provides an exception to this general principle by requiring that such assessment **should be done on the date of transition to Ind AS**.

Ind AS 101 further provides that if it is impracticable to assess the below mentioned features of a financial asset as at the date of transition to Ind AS, the "contractual cash flow characteristics test" shall be done without taking into account those features:

- Modified time value of money element
- Significance of the fair value of a prepayment feature

Ind AS 109 requires the measurement of amortised cost of a financial asset or a financial liability using effective interest method. As an exception to this general measurement principle, Ind AS 101 provides 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 AS shall be the new gross carrying amount of that financial asset or the new amortised cost of that financial liability at the date of transition to Ind AS**.

6. Derecognition of financial assets and liabilities

A first-time adopter shall apply the derecognition requirements in Ind AS 109 prospectively for transactions occurring on or after the date of transition to Ind AS.

Example 4:

If a first-time adopter derecognised non-derivative financial assets or non-derivative financial liabilities in accordance with its previous GAAP as a result of a transaction that occurred before the date of transition to Ind AS, it shall not recognise those assets and liabilities in accordance with Ind AS

7. Impairment of financial assets

An entity shall apply the impairment requirements of Ind AS 109 retrospectively subject to the below:

- At the date of transition to Ind AS, an entity shall use reasonable and supportable information that is available without undue cost or effort to determine the credit risk at the date that financial instruments were initially recognised.
- An entity is not required to undertake an exhaustive search for information when determining, at the date of transition to Ind AS, whether there have been significant increases in credit risk since initial recognition.
- If, at the date of transition to Ind ASs, determining whether there has been a significant increase in credit risk since the initial recognition of a financial instrument would require undue cost or effort, an entity shall recognise a loss allowance at an amount equal to lifetime expected credit losses at each reporting date until that financial instrument is derecognised, unless that financial instrument is low credit risk at a reporting date.

8. Embedded derivatives

A first-time adopter shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed at the later of (a) the date it first became a party to the contract and (b) the date a reassessment is required by Ind AS 109 i.e. when there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract.

8.2 OPTIONAL EXEMPTIONS

(From application of other IndAS)

1. Exemptions for Business Combinations:

Ind AS 103 need not be applied to combinations before date of transition. But, if one combination is restated, all subsequent combinations are restated.

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.

There won't be any change in classification from previous GAAP.

For example 5: if the "pooling of interests" method is applied as per AS 14, the balances of assets and liabilities arising therefrom shall be carried forward.

Another example is regarding the identification of the acquirer - irrespective of the fact that a business combination could have been a reverse acquisition as per Ind AS 103, the accounting adopted in previous GAAP shall be continued.

Measurement exemptions:

- If an asset acquired or liability assumed was not recognized in previous GAAP but would have been recognised in Ind AS, it shall not have a deemed cost of zero and shall be measured at the amount at which Ind AS would require it to be measured. The resulting change is recognised in retained earnings.
- If an asset acquired or liability assumed was recognized in previous GAAP but Ind AS would require its subsequent measurement at other than original cost (for example, investments in certain equity instruments as per Ind AS 109), it shall be measured at such basis and not its original cost. The resulting change is recognised in retained earnings. Refer Example 5 below.

In all other cases, no measurement adjustment shall be made to the carrying amounts of the assets acquired and liabilities assumed.

- Therefore, it should be evident that the balance of goodwill or capital reserve as per previous GAAP is not adjusted for any reason other than:

Recognition of an intangible asset that was earlier subsumed in goodwill or capital reserve but Ind AS requires it to be recognised separately; or

- Vice versa, an asset that was recognised as an intangible asset under previous GAAP but is not permitted to be recognised as an asset under Ind AS.
- Regardless of whether there is any indication that the goodwill may be impaired, the goodwill has to be tested for impairment at the date of transition to Ind AS and any resulting impairment loss is to be recognised in retained earnings (or, if so required by Ind AS 36, in revaluation surplus). The impairment test is based on conditions at the date of transition to Ind AS.

Example 6

If the acquirer had not, in accordance with its previous GAAP, capitalised leases acquired in a past business combination in which acquiree was a lessee, it shall capitalise those leases in its consolidated financial statements, as Ind AS 116, would require the acquiree to do in its Ind AS Balance Sheet.

Similarly, if the acquirer had not, in accordance with its previous GAAP, recognised a contingent liability that still exists at the date of transition to Ind AS, the acquirer shall recognise that contingent liability at that date unless Ind AS 37 would prohibit its recognition in the financial statements of the acquiree.

2. Share-based Payment Transactions:

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.

3. Deemed Cost:

Meaning of Deemed Cost - An amount used as a surrogate for cost or depreciated cost at a given date. Subsequent depreciation or amortisation assumes that the entity had initially recognised the asset or liability at the given date and that its cost was equal to the deemed cost.

An entity may elect to measure an item of property, plant and equipment or an intangible asset at the date of transition to Ind AS at its fair value and use that fair value as its deemed cost at that date.

A first-time adopter may elect to continue with the carrying value (i.e original cost less accumulated depreciation less accumulated revaluations if any less accumulated impairments if any) for all of its property, plant and equipment as recognised in the financial statements as at

the date of transition measured *as per the previous GAAP* and use that as its deemed cost. This exemption is also applicable to intangible assets and investment property.

Be careful - This exemption is not available on asset by asset basis - its for all assets.

For Investment Property

Ind AS 40, Investment Property permits only the cost model. Therefore, option of availing fair value as deemed cost for investment property is not available for first time adopters of Ind AS for its financial statements.

4. Cumulative Translation Difference

No need to:

1. Recognise some translation differences in other comprehensive income.
2. Reclassify cumulative translation differences for foreign operation from equity to profit or loss as part of gain or loss on its disposal

If first time adopter uses this exemption:

- a. Cumulative translation differences set to zero for all foreign operations.
- b. Gain / loss on subsequent disposal of a foreign operation shall exclude these differences that arose before transition

5. Long-term Foreign Currency Monetary Items:

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.

To be clear, this exemption is not a permanent exemption from the requirements of Ind AS 21. It is available only for those long-term foreign currency monetary items which are recognised before the first Ind AS reporting period began. For example, if the transition date is 1 April 20X5, the first reporting period will be 1 April 20X6 to 31 March 20X7. Therefore, this exemption is available only if such monetary items were recognised in the last previous GAAP financial statements i.e. financial statements for the year ended 31 March 20X6.

6. Investments in Subsidiaries, Joint Ventures and Associates

When an entity prepares separate financial statements, Ind AS 27 requires it to account for its investments in subsidiaries, joint ventures and associates either:

- (a) at cost; or
- (b) In accordance with Ind AS 109.

If a first-time adopter measures such an investment at cost in accordance with Ind AS 27, it shall measure that investment at one of the following amounts in its separate opening Ind AS Balance Sheet:

- (a) cost determined in accordance with Ind AS 27; or

(b) Deemed cost. The deemed cost of such an investment shall be its:

- (i) fair value at the entity's date of transition to Ind AS in its separate financial statements; or
- (ii) Previous GAAP carrying amount at that date.

A first-time adopter may choose either (i) or (ii) above to measure its investment in each subsidiary, joint venture or associate that it elects to measure using a deemed cost.

7. Compound Financial Instruments

A first-time adopter need not split the compound financial instruments into separate liability and equity component, if liability component not outstanding as at transition date.

8. Decommissioning liabilities included in Property, Plant and Equipment

An entity need not comply with this requirement for changes in such liabilities that occurred before the date of transition. If an entity avails of this exemption, it shall:

- Measure the liability as at the transition date as per Ind AS 37 i.e. based on the facts and circumstances, including the risk-adjusted discount rate, as at the transition date
- Calculate accumulated depreciation on the transition date on the basis of estimated useful life as at that date.

9. LEASES

A first-time adopter may determine whether an arrangement existing at the date of transition to Ind AS contain a lease (including classification by a lessor of each land and building element as finance or an operating lease) on the basis of facts and circumstances existing on the date of transition. A lessee which is a first-time adopter of Ind AS shall recognise lease liabilities and right-of-use assets, by applying the following approach to all of its leases at the date of transition to Ind AS:

- (a) Measure a lease liability at the present value of the remaining lease payments discounted using the lessee's incremental borrowing rate at the date of transition to Ind AS;
- (b) measure a right-of-use asset on a lease-by-lease basis either at:
 - (i) Its carrying amount as if Ind AS 116 had been applied since the commencement date of the lease, but discounted using the lessee's incremental borrowing rate at the date of transition to Ind AS; or
 - (ii) an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the Balance Sheet immediately before the date of transition to Ind AS.
- (c) apply Ind AS 36 to right-of-use assets.

A first-time adopter that is a lessee may do one or more of the following at the date of transition to Ind AS, applied on a lease-by lease basis:

- (1) apply a single discount rate to a portfolio of leases with reasonably similar characteristics.
- (2) elect not to apply the above requirements given in (a) to (c) to leases for which the lease

term ends within 12 months of the date of transition to Ind AS. Instead, the entity shall account for (including disclosure of information about) these leases as if they were short-term leases accounted as per Ind AS 116.

- (3) elect not to apply the above requirements given in (a) to (c) to leases for which the underlying asset is of low value. Instead, the entity shall account for (including disclosure of information about) these leases as per Ind AS 116.
- (4) exclude initial direct costs from the measurement of the right-of-use asset at the date of transition to Ind AS.
- (5) use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease.

10. Non-current assets held for sale and discounted operations

A first-time adopter can:

- Measure noncurrent assets held for sale or discontinued operation at the lower carrying value and fair value less cost to sell at the date of transition to Ind AS in accordance with Ind AS 105; and
- Recognize directly in retain earnings any difference between that amount and the carrying amount of those assets at the date of transition to Ind AS determined under the entity's previous GAAP

11. Joint Arrangements

Transition from Proportionate Consolidation to Equity Method

- ❖ To measure initial investment at transition date at the aggregate of carrying amount of assets and liabilities that had previously proportionately consolidated including goodwill arising on acquisition.
- ❖ To test the investment for impairment.
- ❖ If aggregate of all previously recognized assets/liabilities results in negative asset and if having legal or constructive obligation than recognize corresponding liability otherwise adjust retained earnings.

Transition from Equity Method to accounting for assets and liabilities

- ❖ To derecognize previous investment and recognize share of each asset and liability in respect of its interest in joint operation.
- ❖ Difference between amount as per Ind AS and previously recognized:
 - (a) If carrying amount of previous investment is lower:
Offset against goodwill relating to investment and thereafter retained earning
 - (b) If carrying amount of previous investment is higher:
Adjust against retained earning

Transitional provisions in entity's Separate FS

- ❖ To derecognise the investment and recognise assets and liabilities as per transition from equity method to accounting for assets and liabilities

- ❖ Provide reconciliation between amount derecognized, recognized and adjustment to retained earnings.

12. Fair value measurement of financial assets or financial liabilities

As per Ind AS 109, if:

- the fair value of the financial asset or financial liability at initial recognition differs from the transaction price, and
- such fair value is not based on:
 - ❖ Level 1 inputs (refer Ind AS 113), or
 - ❖ Valuation technique that uses only data from observable markets

then, such difference (referred to in first bullet above) is deferred and amortised in profit or loss on the basis stated in Ind AS 109.

Ind AS 101 permits an entity to apply this requirement of Ind AS 109 prospectively to transactions entered into on or after the date of transition

13. Designation of previously recognised financial instruments

All financial instruments are initially measured at fair value. As regards subsequent measurement, Ind AS 109 permits that upon initial recognition, an entity may designate financial instruments as subsequently measured at fair value if certain criteria are met. Ind AS 101 exempts an entity from retrospective designation of financial instruments and permits that such designation be done on the basis of the facts and circumstances that exist at the date of transition to Ind AS. In particular the exemption is provided for below mentioned financial instruments:

- ❖ Designation of any financial liability or asset at fair value through profit or loss
- ❖ Designation of investment in an equity instrument at fair value through other comprehensive income

14. Extinguishing financial liabilities with equity instruments

Appendix D of Ind AS 109 provides for accounting principles to be applied when an entity's equity instruments are issued to extinguish all or part of its financial liability. A first time adopter may apply Appendix D of Ind AS 109 from the date of transition to Ind AS.

15. Financial asset or intangible assets accounted for in accordance with Appendix D to Ind AS 115, Service Concession Arrangements

Change in accounting policy pursuant to the requirements of this Appendix to be accounted for retrospectively except for amortization policy for intangible assets relating to toll roads adopted as per previous GAAP.

If impracticable for an operator to apply the requirements of the Ind AS retrospectively at the date of transition to Ind AS, it shall recognise financial assets and intangible assets that existed at the date of transition to Ind AS using the previous carrying amounts.

16. Striping costs in the production of surface mine

A first time adopter may apply Appendix B to Ind AS 16, Stripping costs in the production phase of a surface mine, from the date of transition to Ind AS. As at the transition date to Ind AS, any previously recognised asset balance that resulted from stripping activity undertaken during the production phase shall be reclassified as a part of an existing asset to which the stripping activity related, to the extent that there remains an identifiable

17. Assets and liabilities of subsidiaries, associates and joint ventures

If a subsidiary becomes a first-time adopter later than its parent, the subsidiary shall measure its assets and liabilities at either:

- The carrying amounts that would be included in the parent's consolidated financial statements, based on the parent's date of transition to Ind AS. or
- The carrying amounts required by Ind AS 101, based on the subsidiary's date of transition to Ind AS.

If an entity becomes first time adopter later than its subsidiary, the entity shall measure the assets and liabilities at the subsidiary at the same carrying amounts as in the financial statements of the subsidiary, after adjusting for consolidation and equity accounting adjustments and for the effects of the business combination in which the entity acquired the subsidy.

18. Revenue from Contract with Customers

Any of the following exemption may be used in applying Ind AS 115 retrospectively:

- For completed contracts: Need not restate contracts that begin and end within the same annual reporting period;
- For completed contracts that have variable consideration: Option to use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods;
- For all reporting periods presented before the beginning of the first Ind AS reporting period, an entity need not disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when the entity expects to recognize that amount as revenue.

9. PRESENTATION AND DISCLOSURE

Comparative Information

- Ind AS does not require historical summaries to comply with the recognition and measurement requirement of Ind AS.
- In any financial statements containing historical summaries or comparative information in accordance with previous GAAP, an entity shall:
 - ❖ Label the previous GAAP information prominently as not being prepared in accordance with Ind AS; and
 - ❖ Disclose the nature of the main adjustments that would make it comply with Ind AS. An entity need not quantify those adjustments.

Provide Reconciliation of

- (a) Equity from previous GAAP to Ind AS at transition and last year end;
- (b) Last year's total comprehensive income under previous GAAP to Ind AS.

10. CARVE OUTS IN INDAS 101 FROM IFRS 1

- (i) **Allowing the use of Carrying Cost of Property, Plant and Equipment (PPE) on the Date of Transition of Ind AS 101.**

As per IFRS: IFRS 1 *First time adoption of International Accounting Standards* provides that on the date of transition either the items of Property, Plant and Equipment shall be determined by applying IAS 16 'Property, Plant and Equipment' retrospectively or the same should be recorded at fair value.

Carve out: Ind AS 101 provides an additional option to use carrying values of all items of property, plant and equipment on the date of transition in accordance with previous GAAP as an acceptable starting point under Ind AS.

Reason: In case of old companies, retrospective application of Ind AS 16 or fair values at the date of transition to determine deemed cost may not be possible for old assets. Accordingly, Ind AS 101 provides relief to an entity to use carrying values of all items of property, plant and equipment on the date of transition in accordance with previous GAAP as an acceptable starting point under Ind AS.

- (ii) **Long-term Foreign Currency Monetary Items**

As per IFRS: No provision in IFRS 1.

Carve out: Ind AS 101 provides that a first-time adopter may continue the policy adopted for accounting for exchange differences arising from translation of long-term foreign currency monetary items recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP.

Consequently, Ind AS 21 also provides that it does not apply to long-term foreign currency monetary items for which an entity has opted for the exemption given in paragraph D13AA of Appendix D to Ind AS 101. Such an entity may continue to apply the accounting policy so opted for such long-term foreign currency monetary items.

Reason: AS 11 provides an option to recognise long term foreign currency monetary items in the statement of profit and loss as a part of the cost of property, plant and equipment or to defer its recognition in the statement of profit and loss over the period of loan in case the loan is not related to acquisition of fixed assets. To provide transitional relief, such entities have been given an option to continue the capitalisation or deferment of exchange differences, as the case may be, on foreign currency borrowings obtained before the beginning of First IFRS reporting period.

(iii) Land and building element in lease contracts

As per IFRS

No provisions under IFRS 1.

Carve Out

Paragraph D9AA provides that an entity which is a lessor can use the transition date facts and circumstances for lease arrangements which includes both land and building elements to assess the classification of each element as finance or an operating lease at the transition date to Ind AS. Also, if there is any land lease newly classified as finance lease then the first-time adopter may recognise assets and liability at fair value on that date; any difference between those fair values is recognised in retained earnings.

Reason

This aspect is quite common in the Indian environment and it was felt that the first-time adopters may face hardship if they were to retrospectively assess the two elements of the contract.

(iv) Intangible assets arising from service concession arrangements related to toll roads accounted for in accordance with Appendix D, Service Concession Arrangements to Ind AS 115, Revenue from Contracts with Customers

As per IFRS

No provision in IFRS 1.

Carve Out

Ind AS 101 permits a first-time adopter to continue with the policy adopted for amortization of intangible assets arising from service concession arrangements related to toll roads recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP.

As a consequence to the above, paragraph 7AA has been inserted in Ind AS 38 to scope out the entity, to apply amortisation method, that opts to amortise the intangible assets arising

from service concession arrangements in respect of toll roads recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS reporting period as per the exception given in paragraph D22 of Appendix D to Ind AS 101.

Reason

Schedule II to the Companies Act, 2013, allows companies to use revenue based amortisation of intangible assets arising from service concession arrangements related to toll roads while Ind AS 38, Intangible Assets, allows revenue based amortisation only in the circumstances in which the predominant limiting factor that is inherent in an intangible asset is the achievement of revenue threshold. In order to provide relief to such entities, Ind AS 38 and Ind AS 101 have been amended to allow the entities to continue to use the accounting policy adopted for amortization of intangible assets arising from service concession arrangements related to toll roads recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial statements. In other words, Ind AS 38 would be applicable to the amortisation of intangible assets arising from service concession arrangements related to toll roads entered into after the implementation of Ind AS.